CENTER FOR INSTITUTIONAL REFORM AND THE INFORMAL SECTOR

University of Maryland

Center Office: IRIS Center, 2105 Morrill Hall, College Park, MD 20742
Telephone (301) 405-3110 Fax (301) 405-3020
http://www.iris.umd.edu/

CHANGING HANDS: A CASE STUDY OF FINANCIAL SECTOR GOVERNANCE IN HUNGARY'S MARKET TRANSITION

Patrick Meagher

November 2000

Working Paper No. 245

USAID PCE-I-00-97-00042-00

Acknowledgements: This study owes its existence in significant part to the contributions of Joel Turkewitz and Petra Reszketo. Numerous officials and experts in Hungary gave generously of their time, candor, and information sources. They are gratefully acknowledged but their names are not provided here in the interest of confidentiality. Sarah Bell, Mushfiq Mobarak, and Zarines Negron of IRIS also provided invaluable help. All opinions and shortcomings herein are the author's alone.

TABLE OF CONTENTS

TEXT BOXES PAGE

TABLES PAGE

FIGURES PAGE

List of Abbreviations

APV Rt	State Privatization and Holding Company
BCCI	Bank of Credit and Commerce International
CEO	Chief Executive Officer
COMECON	Council for Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
EIU	Economist Intelligence Unit
EU	European Union
FDI	Foreign Direct Investment
FIDESZ	Federation of Young Democrats
GDP	Gross Domestic Product
GKO	Russian Treasury Bond
HUF	Hungarian forint (currency)
IMF	International Monetary Fund
IPB	*Investnici Postovni Banka*
IPO	Initial Public Offering
IRIS	Center for Institutional Reform and the Informal Sector
IT	Information Technology
JV	Joint Venture
K&H	*Kereskedelmi es Hitel Bank*
MFB	Hungarian Development Bank
MHB	*Magyar Hitel Bank*
MKB	Hungarian Foreign Trade Bank
MOF	Ministry of Finance
NBH	National Bank of Hungary
OECD	Organization for Economic Cooperation and Development
OTP	National Savings Bank of Hungary
SME	Small and Medium-sized Enterprise
S&L	Savings and Loan
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise
SPA	State Property Agency
TVE	Town and Village Enterprise (China)
USAID	United States Agency for International Development

Exchange Rates

mid-2000:	273.72 HUF = US $1
mid-1996:	148.32 HUF = US $1

Chapter I: Introduction

Financing the growth of a modern economy creates long chains of agency relationships. No country has institutions that can safeguard all these relations from abuse all the time. By now, most readers have encountered tales of unchecked moral hazard, and the frequent outcomes, dirty banks and financial crises. Like other governance challenges, this one shows itself to be especially severe in poorer countries on the development path or in transition from socialism. There, both state institutions and the rule frameworks governing markets are evolving, but often prove incapable of containing opportunism, fraud, and corruption. The gaps and anomalies in these structures invite exploitation, usually with grim consequences.

Recent history is littered with costly financial disasters. A few major ones immediately come to mind:

- The U.S. Savings and Loan (S&L) crisis of the late 1980s;
- The BCCI scandal of the early 1990s;
- The Mexican peso crisis of 1994;
- Pyramid collapses and crises in Russia, Bulgaria, and Albania in 1995-7;
- The East Asian crisis of 1997;
- The Russian ruble crisis of 1998.

Each one of these involved some form of corruption, from induced regulatory failure to crony-driven bank licensing to massive theft under a thin veneer of state policy.[1] The costs of each episode were enormous for the affected governments, economies, and populations.

History repeats itself in scandals that continue to unfold. For example, in one of the major scandals plaguing the recovery and political transition in Indonesia, the central bank and the bank restructuring authority have been accused of funneling over $60 million through an insolvent bank and a front company, to the former ruling party. The Bank Bali affair has led to detention and criminal charges against the governor of Indonesia's central bank.[2] More recently, four Egyptian members of parliament and 27 others were jailed for up to 15 years for corruption, in connection with some $500 million in politically-motivated unsecured loans arranged by businessmen and bankers close to the ruling party.[3]

The present case study deals with the problems arising in post-socialist transition environments, which have proven especially severe and intractable. The phenomenon of "oligarch" banks in Russia is relatively well-known, but by no means unique. Major banking scandals have also hit Romania and Croatia recently, leading to accusations of bank involvement in political corruption, the resignations of senior officials, and criminal investigations.[4]

Even the most advanced transition countries have not escaped this syndrome. On June 16, 2000, armed anti-terrorist police arrived at *Investnici Postovni Banka*, the third largest Czech bank to place it under forced administration. IPB had a reputation as "rotten" – trouble came

---

[1] This is not to suggest that corruption outweighed all other factors, such as short-term credit flows or regulatory weaknesses, as a direct influence on the results.
[2] "Indonesia Jails Central Banker," *International Herald Tribune*, June 22, 2000, p 14.
[3] "Four MPs Among 31 Jailed in Egypt Loan Scandal," *The Island* (Sri Lanka), June 26, 2000, p 5.
[4] "Another Romanian Banking Official Detained," *RFE/RL Newsline*, June 7, 2000; "Bank Scandal Hits Croatian Coalition," *RFE/RL Newsline*, March 28, 2000; "Croatian Bank Chiefs Quit," *RFE/RL Newsline*, April 27, 2000.

when depositors withdrew $450 million in a week, responding to rumors of an imminent audit. The Czech Finance Minister estimated that IPB would have had losses equaling two to four percent of GDP, and officials suggested that some $300 million may have been siphoned off to foreign accounts by bank managers. Political leaders called for a parliamentary investigation, suggesting that IPB and the seizure had been manipulated by a corrupt alliance of politicians and financiers. Also in recent months, *Komercni Banka*, the largest commercial bank in the Czech Republic (still under state ownership but to be sold later this year), has been facing scandal. Eleven top managers were charged in connection with an unsecured loan of $200 million, representing 90 percent of the value of the bank's shares on the stock exchange, to a foreign company that has since gone bankrupt. The Czech government had already paid more than 8% of GDP to clean up the banks in the mid-1990s.[5]

The task of the present case study is to examine a set of responses that proved successful in curbing these kinds of abuses, and in doing so to suggest how the lessons of those experiences might prove useful to others confronting similar problems. The case concerns the reform path taken by Hungary, which eventually created one of the strongest financial systems in the region. This outcome had to emerge from a stew of hazy corporate networks, official cronyism, and corruption, through a painful series of changes.

"Changing Hands," as the title of this case has it, should be understood in several ways. Most obviously, market transition requires that banks, enterprises, and economic decisions move from exclusive state control to being predominantly in private hands. The emerging market needs to help transfer assets into the hands of their most efficient users. The "grabbing hand" of the state should become less important in the economy, and the "invisible hand" of the market much more so.[6] Importantly, the environment being established should not be one where political capital automatically translates into private economic capital, where state monopolies become private ones, and the state becomes a personal tool of individual oligarchs. In short, disguising the grabbing hand in the "velvet glove" of private or mixed ownership won't do.[7] Finally, corporate governance and public sector integrity are intimately linked, especially where the boundaries between public and private sectors are not sharply defined.[8] Nowhere is this more evident than in the financial system.

The present case study is one of a series commissioned by the USAID Democracy and Governance Center and developed by the IRIS Center for purposes of highlighting lessons from attempts to curb corruption around the world. The current study embodies the substantial research efforts of the author as well as other researchers in the U.S. and Hungary. This included two weeks of fieldwork by the author in Hungary, involving dozens of interviews with officials, bankers, and independent experts, and the collection of a large mass of documentation – on a well-documented transition. At this point, we would like to restate our indebtedness to USAID, while emphasizing that the content of this work in no way embodies its official viewpoint.

---

[5] "The Last Crisis," *The Economist*, June 24, 2000, p 104; Green, Peter, "Prague Takes Over No. 3 Bank," *International Herald Tribune*, June 17-18, 2000, p 11; "Czech Opposition Leader Wants Investigation of Troubled Bank's Sale," *RFE/RL Newsline*, June 23, 2000; "Czech Bankers Charged," *RFE/RL Newsline*, May 11, 2000.
[6] Shleifer and Vishy (1998).
[7] Stiglitz (1999).
[8] This is the defining characteristic of the "soft" state mentioned below.

Summary

The early 1990s in Hungary were marked by rapid institutional change and severe economic downturn. In this atmosphere of flux, state assets moved into private hands through a host of licit and illicit means, while banks and enterprises had to improvise in order to stay afloat, frequently colluding to defraud investors or creditors and misreporting their financial status to regulators. Credit relations and the financial system generally suffered from a number of governance failures. Budget constraints were soft, credit allocation politicized and personalized, and corruption rampant. The forms of *financial corruption* included these:

* Loans extended on the basis of bribes, political influence, or crony relationships, many if not most of which were fraudulent and were never repaid. The funds often went into illicit acquisitions, and the enterprises frequently failed (and sometimes the banks as well).

* Self-enrichment schemes, including the diversion of state assets into private hands, self-dealing by banks and enterprises (i.e. theft from the owners), and the founding of questionable banks – some of them "pocket" operations designed to channel funds to related persons or corporations.

* Rigging or manipulation of such procedures as bankruptcy and privatization auctions, state-initiated debt restructuring programs, and bank supervision processes. These activities usually benefited politically-connected interests either directly or through a less direct exchange.

In all these cases, the "soft" state of early post-socialist transition became a tool for narrow interests to capture funds, assets, opportunities, and relationships that were, or should have been, preserved in trust for the public at large. The cost of this early rash of corruption, and later episodes through the 1990s, easily runs into the hundreds of millions of dollars.

Many countries in similar circumstances have failed to come to grips with these problems, with disastrous results – the paradigm example being Russia's experience leading up to the crisis of 1998. There, rapid privatization (in the absence of functioning safeguards and market institutions) opened the door to massive self-enrichment by enterprise insiders, and the recycling of funds through a loosely supervised banking system. This led to the rise of oligarchs who bent the system to their will, creating public giveaways and a culture in which lobbying and self-dealing trumped the profit motive. Hungary saw the beginnings of this in the early 1990s. Its experiments with market socialism had ushered in a complex and murky business environment. Hybrid (state-private) corporate groups, in many cases run by (former) state managers, linked enterprises, banks, and the state in an often collusive mutual embrace. Studies elsewhere have shown the governance failures that arise (with resulting underperformance and vulnerability to crises) where financial institutions are predominantly conglomerate- or state-owned, especially in emerging markets. In these situations, financial flows often depend far more on politics and personal networks than on transparent accounts and legal arrangements.

What could be done about this? Focusing on a direct assault against corruption would likely prove wasteful at best, if not disastrous, in a context where market institutions and the rule of law have only just begun to emerge. This suggests that establishing effective governance in the economy must be among the first priorities for a number of reasons, including the reversal of heavily corrupt incentives. Thus, the choices confronting Hungary in the early 1990s were tough, and the stakes high. Should privatization be rapid or gradual? Should market institutional reform be strict and sudden, or slow and accommodating? Should banking reform center on existing institutions or rapid influx of new ones?

Hungary escaped the trap of failed transition, with its downward spiral of distortion, stagnation, and corruption. In this, reformers were significantly helped by binding fiscal constraints, outside pressure, and constituencies for change created by Hungary's prior market experiences. The gathering strength of judicial and audit institutions, and of pluralism in the political system, also contributed much to the outcome. However, the reform path was neither easy nor straight – it included:

"*Legislative shock therapy*," a bold effort in 1991-2 to impose financial transparency, modern prudential regulation, and hard budget constraints through legislation. New laws on accounting, banking, and bankruptcy were enacted. These proved too strict in the near term, causing a rapid rise in insolvencies and bad debt portfolios, while at the same time encouraging collusive evasion of the rules and opportunistic asset grabs. It appears that legislative change could not achieve the anticipated governance benefits while incentives and ownership structures pointed in the opposite direction. Over the longer term, these laws, in amended form, provided a basis for financial transparency and discipline.

Debt restructuring, in which enterprise debts were worked out and the banks (which were largely insolvent by late 1992) recapitalized, in 1992-4. The inadequate resources and flawed design of the initial programs led to repeated bailouts, until a new government came to power and signaled that the bailouts would end, to be replaced by more vigorous restructuring and privatization.

Privatization, which was intensified and expanded to include case-by-case sales of government holdings in the banking sector, in 1995-7. The key feature of these privatizations was the divestment of large shareholdings to strategic foreign investors. This approach brought private ownership up to 80% of assets overall, with foreign investors holding over 50% of manufacturing sector assets, and over 60% of the banking sector by the late 1990s.

These reforms revolutionized ownership incentives and imposed transparency on the system. The influx of foreign owners, together with the growing strength of markets and public sector institutions, brought banks and enterprises under the effective discipline of corporate governance and regulation. This helped create one of the strongest financial sectors in the region, a vibrant economy, and a reasonably well-governed and competitive marketplace. Corruption in the financial system, nearly a way of life in 1991, has become far more episodic and manageable. This does not mean there are no clouds on the horizon. A major corruption scandal at Postabank prompted costly state intervention and criminal investigations, with similar problems on a smaller scale occurring in the 1997 privatization of K&H Bank and more recently in the state development bank. These events raise some questions, notably about the independence of banking supervision. Still, having significantly improved both corporate governance and state oversight institutions, and having substantially divested its holdings in the real and financial sectors, Hungary is poised to emerge from its market transition. The disciplines imposed by the applicable international regimes, especially the EU, have played an important role.

What *lessons* do these experiences suggest to reformists in other developing and transition countries? These would include:

- *Strong governance and curtailed corruption cannot simply be legislated or imposed through crackdowns – a comprehensive shift in property relations and market incentives is often equally if not more important.*

- *Rapidly building a modern market framework is critical, in order to channel commercial behavior toward value-creation and away from reliance on self-dealing and lobbying.*

- *Incrementalism can succeed, enabling government to build legal-regulatory frameworks before large-scale divestment and to choose "good" strategic owners for privatized banks and firms.*

- *High levels of foreign direct investment – especially by strategic investors operating in other transparent competitive markets -- are fundamental to timely emergence of sound banking and corporate governances.*

- *Binding outside constraints, such as international regimes and fiscal deficits, can speed reform by limiting choices and providing political cover.*

- *"Hard budget constraints" are important, but arise as much from credible political signals shutting off state support, and from organizational incentives, as from legislation.*

- *State ownership can be disciplined and made accountable if it is small enough, especially where competitive markets and political pluralism have grown sufficiently strong.*

Chapter II: The Problem

We begin with a review of the kinds of corruption that surfaced during Hungary's early transition phase, beginning in the late 1980s and reaching their peak in the early 1990s. Observers of the Hungarian economy in the early 1990s could hardly be blamed at the time for seeing the glass as half-empty. During the transition crisis of 1989-93, GDP and industrial output contracted by 18 and 25 percent respectively. Unemployment rose to about ten percent, inflation climbed beyond 33 percent, and bankruptcies soared to over ten thousand.[9] Firms had to find ways of coping with the severe shrinkage of their markets. They struggled to meet payrolls, obtain basic inputs, and defer tax payments. Debtors and creditors badly needed to work out arrangements that would keep businesses afloat. At the same time, restructuring and privatization were moving control of state-owned means of production into private hands at an uneven, yet unprecedented, rate. These dislocations presented opportunities to those able to gain access to productive assets and to exploit insider knowledge and connections. As in most transition environments across the former Soviet bloc, this flux bred speculation, fraud, theft, and corruption.

Hungary's productive sectors were still dominated by state-owned enterprises (SOEs) as the 1990s began. The government, via the state-owned commercial banks (SOCBs) directed credit to selected firms, mainly agribusinesses, but essentially ignored the credit needs of small, medium-sized, and start-up firms. One observer described the situation as one of "absolute moral hazard": no one was held responsible when loans were extended or rolled over to non-paying firms. Though they were in reality insolvent, banks were considered "profitable" since they counted unpaid interest as income and were not required to provision against non-performing loans. Loan officers' incentives carried over more or less intact from the communist system: they were essentially expected to give loans as required by client enterprises (and their bureaucratic and political masters). Not surprisingly, some observers found "rampant" bank corruption in Hungary during the early to mid-1990s.[10]

In short, credit allocation became to a significant extent personalized, politicized, and corrupt. The absence of competition, disciplining mechanisms, and transparency meant that this situation could continue unchallenged. Among the varieties of corruption practiced in Hungary, certain methods depended on the use of official authority to direct resources and advantages to individuals. These practices usually touched the financial system, as they involved either banks, other credit sources, purchases of assets or shares, or the use of state funds.[11] Corrupt financial practices thus affected the financial sector but also extended beyond it. They included the following:[12]

Loans for bribes: Fraudulent lending is thought to have taken place in at least 25-30 banks and cooperatives, especially in rural areas, during the early 1990s, including arrangements

[9]Unemployment figures for 1992 range between 9% and 13%. Hungarian Central Statistic Office, Annual Reports; Economist Intelligence Unit (1999); Bonin and Schaffer (1999).
[10]Fletcher (1995).
[11] Corrupt lending, like other forms of corruption, is difficult to prove. Some observers suggest that Hungarian cronies used the transition crisis as cover for corrupt loans – i.e., that "sending good money after bad" in some cases had a corrupt motivation, a statement that can only be assessed, if at all, in individual cases.
[12] This presentation, like others that follow, relies substantially on interview findings and observations of researchers that have been cross-checked for consistency.

in which bribes or favors were exchanged for dubious loans.[13] It was also widely believed that banks frequently extended financing to shaky projects and clients, where the likelihood of repayment was highly imperfect at best. One type of arrangement apparently involved bank staff providing loans to firms with limited assets, in return for kickbacks. These loans were used by enterprise managers to buy up the assets of their firms (better than buying the company itself, since this evaded existing debt) and the useful loan officer would be rewarded for making capital available. In a variant of this, a bank CEO would be approached for a loan and invited to visit the applicant enterprise's premises. There, the borrower would promise to help the CEO to buy land at a reduced price, and in return the firm would receive a loan with no expectation of repayment.

Crony lending: In this environment, the process of granting new loans, or rolling over old loans, was hazy as well as heavily politicized and inefficient. The period from 1989 to 1992 saw the pinnacle of bad banking practices – the granting of loans to insiders, managers, and to political allies. This behavior appears to have extended, perhaps in reduced form, into the mid-1990s. Banking malfeasance followed a familiar general pattern during this period: collusion between the bank and the enterprise client to extend a questionable loan, non-payment (as expected), a threat of insolvency or bank failure, followed by a government bailout. Traditionally, a banker would receive a telephone call from a minister instructing him/her to lend to firm X, and then do so in order to preserve her/his job and to ensure career advancement. This kind of direct "telephone lending" is thought to have died out during the early 1990s, and to have been replaced with more subtle methods where official involvement was less evident.

Bribery and crony lending appear often to have gone hand-in-hand. Features of both types of abuse included credit misallocation (financial flows to clients chosen for reasons other than their ability to use credit efficiently and repay, a type of "adverse selection"), *ex ante* expectations of at best delayed or partial repayment (an example of what is widely known as a "soft budget constraint," see Box 1), and in many cases the insolvency of the bank or the enterprise or both (at least in some cases by design). These practices came to light in a number of bank scandals during the early to mid-1990s. The collapse of Ybl bank was found to have been brought about by practices such as the fraudulent multiple discounting of bills of exchange, unsecured loans to major investors in the bank, and bribery. Senior managers and board members were charged with corruption and banking malpractice resulting in the loss of 6 billion Hungarian forints (HUF), some of them receiving prison terms of up to four years. At the AVB and GSB banks, fraud by bank managers, unsecured loans to investors, and other malfeasance led to the banks' insolvency and collapse.[14]

[13]Fletcher (1995).
[14] Fletcher (1995). According to some observers, these banks were not among the large major banks, and their relatively small size and minor status may have enabled unscrupulous investors to purchase and use them for their own purposes, and in doing so to avoid scrutiny.

Box 1
Soft Budget Constraints

Relationships among government and state-owned banks and enterprises are frequently subject to "soft budget constraints" a term coined by Hungarian economist Janos Kornai two decades ago. Kornai saw the soft budget constraint mainly as a feature of socialist paternalism. Later theorists (notably Dewatripont and Maskin) have suggested that it arises whenever it is *ex post* optimal for a principal (an investor/creditor) to bail out its agent (debtor) instead of liquidating it as a result of losses, since prior invested funds (sunk costs) would be lost. This can occur in largely private market-based financial systems as well as state socialist systems. Hardening budget constraints requires a credible commitment not to refinance. One situation where this becomes difficult is where soft budgets arise from rent-seeking by banks to exploit the "softness" of the state, since liquidation would then eliminate hidden benefits – including those accruing to state officials. (Berglof and Roland 1997) A related approach emphasizes the role of the centralized or "vertical" financial structure typical of socialism in creating soft budget constraints. In this view, decentralization of the financial system is the key to placing a credible restraint on *ex post* renegotiation of debts. For example, China's devolution of financial decisions requires local governments to live within limited means, thereby creating a hard budget constraint analogous to that of a market economy. (Maskin and Xu 1999)

Another model suggests that soft budget constraints may arise from excessive control by corporate insiders. These insiders exercise *de facto* control but usually have very limited ownership claims. Since, as a result, they are shielded from the down-side risks of investments but at the same time do not have significant claims on proceeds from asset liquidations, they have a strong incentive to oppose liquidation and to support continued investments – whether these are profitable or not. In this view, effective control by outsiders helps bring about hard budget constraints, since these investors have an interest in shutting down loss-making firms and avoiding unprofitable investments. Hard budget constraints should deter insiders from carrying out inefficient investments and improve firm profitability. (Li 2000)

The apparent pervasiveness of soft budget constraints in transition economies has resulted in some definitional problems. Some analysts have defined the soft budget restrictively, limiting it to where firms are receiving net new credit rather than simply the deferral of old debts and accumulated interest. It is also important to keep in mind the various sources of firms' soft budget constraints: banks, other firms (trade credit), and the tax authorities. All of these sources are important in the slower-reforming transition countries, but tax arrears take on comparatively greater importance in the rapidly-transforming transition economies, perhaps due to their more effective enterprise and bank restructuring. Facing hard constraints from creditor firms, banks, and employees as well, distressed firms in the latter countries turn to the state for tax relief. By one estimate, tax arrears accumulate at a rate of 1-3% of GDP per year across the post-socialist countries, as compared to a fraction of one percent in industrialized countries. (Schaffer 1997)

The weaker the state, the larger the problem of tax arrears tends to be. An example is provided by the Russian "30-70" rule by which firms that were unable to pay both taxes and wages (taxes have priority over other debts) were permitted to use 30% of their clearing accounts to pay wages, hence to take an indefinite tax deferral of the same amount. This contributed to rapid growth of tax arrears starting in the mid-1990s, hence illustrates the tendency of enterprise lobbying for subsidies to undermine tax discipline – as well as the role of the fiscal system in overall financial governance. (Schaffer 1997) In Russia, the paternalistic state role has in large measure been taken over by regional and municipal governments, which are known to provide not only tax relief but utility discounts and favored status in public procurement – at the same time punishing those that disobey, for example, through troublesome health and safety inspections. Also, overdue accounts receivables between firms amounted to some 40% of GDP in 1999, thus adding substantially to soft budget-driven distortions. (Desai and Goldberg 1999)

Soft budget constraints are not the same as corruption. Rather, they furnish both a *means* for agents of government and private entities to engage in abuses, and a *motive* for corrupt arrangements designed to secure hidden benefits for narrow interests.

Diversion of assets: Hungary established its State Property Agency (SPA) in 1990, for purposes of rationalizing state property holdings and organizing privatizations. Prior to this, from 1987 to 1990, an estimated 150 SOEs (approximately 8% of all SOEs) were "spontaneously" privatized, i.e., had their assets shifted to other entities without notice or compensation to the state (see Box 2). Also, approximately 1,600 new companies were formed in 1988-9 alone, using (partially) state assets.[15] Indeed, some of the larger foreign investment deals involved informal or at best legally murky privatizations. Moreover, once established, the SPA was notoriously slow in privatizing firms—due, in part, to its desire to restructure firms before privatizing and to set a range of conditions for future owners. Many enterprise managers attempted to escape their debts, and in many cases to profit personally, by shifting assets and debts among their firms. Since managers often controlled a ring of firms (usually with over 75% ownership), they had virtually complete freedom to shift assets without obtaining the permission of other parties. Banks are implicated here in a few ways: some were members (or leaders) of corporate groups, some probably facilitated asset-stripping and fraudulent debt washing, and some were established in part with misappropriated capital.

Self-dealing: Banks have been known, even until recently, to have supported various forms of self-dealing by managers and major owners. Related-party loans (loans to owners, board members, employees or their relations) were not regulated at the beginning of Hungary's transition. Even after regulation came in, the complexity of corporate groups and the lack of any capacity by the banking authorities to carry out consolidated supervision (supervision taking into account a broad range of corporate group relationships) suggest that self-dealing was not effectively controlled even in formal terms. In general, conflict of interest prohibitions were essentially unknown. Thus, bank managers were not greatly hindered in extending credit to themselves or related parties, usually through intermediary companies, for a variety of purposes. These could include theft, leveraging a recapitalization of the lending bank, or financing enterprise acquisitions. Asset-stripping by companies (many owned by banks) usually enriched managers at the expense of the state and other owners. Another form of self-dealing that took place until recently was the practice of directing tenders for bank procurements of goods and services (e.g., consulting or IT facilities) to connected contractors in return for kickbacks from over-invoicing.

"Pocket" banks: The early transition period in Hungary, as in neighboring countries and especially Russia, saw the establishment of several small banks that were "banks" in name only. These came into being during a situation of crisis and regulatory flux, when banking law had not yet been reformed to support an emerging financial market, and the regulatory and supervisory functions had not come fully into being. In this context, government organizations and bureaucrats created some small banks as channels for cheap central bank financing for the state-owned enterprises or ministries to which they were linked. Others were founded by entrepreneurs for purposes of financing expanding private business networks on the cheap, or in some cases for money laundering and similar activities. Thus, the initial laxity of oversight and entry requirements, coupled with the cash and assets that were rapidly moving around in spontaneous privatizations and company looting, opened up opportunities for the operation of small, shady banks with connections to corrupt activities and criminal networks. Some of these grew and legitimized themselves, while several others failed, taking their assets with them and leaving empty-handed depositors and investors behind.[16]

[15] Fletcher (1995).
[16] Bonin et al (1998).

Rigged sales and auctions: As mentioned above, managers in many cases took advantage of privatization delays to wash the debt from their firms and to speed up the acquisition process. One approach was to file for bankruptcy, and to buy back enterprise assets in bankruptcy auctions. Since firm assets were frequently hard to determine (as only the manager usually knew what assets the firm had) and bankruptcy procedures were not well publicized (and easily rigged), managers could walk away with their firms' assets relatively quickly and cheaply. Some observers suggest that foreign investors occasionally signed contracts with managers before the process began and fronted the money for the purchase. Other methods involved manipulation of the SPA privatization processes themselves – in some cases with collusion by SPA officials. Here again, banks were sometimes involved, and in general these activities helped undermine transparency and confidence in the financial system.

Bailout profiteering: Another type of manipulation represented a more complicated way to "game" the system, and involved a greater degree of collusion between firms and banks. This type of scheme plagued the debt relief and bank recapitalization programs carried out in the early to mid-1990s (see Chapter IV). In these schemes, banks and enterprises manipulated their official accounts and loan classification figures in order to maximize (and share) write-offs under the recapitalization programs. Official cooperation, or at least incompetence, surely made much of this behavior possible.[17]

Politicized regulation and bank supervision: Throughout the 1990s, episodes of shaky and corrupt banking led to failures, bailouts and scandals. In some cases, it appears that bank regulators who should have been monitoring the situation or taking action, were pressured to "look the other way." Those cases involved political influence exerted on government banking supervisors by officials or politicians close to the banks (and who often received favors from the banks). In some instances, this was known to all the major political factions but subject to a tacit "live and let live" understanding.

[17] Stark (1996).

Box 2
Spontaneous Privatization

"Spontaneous" privatizations in Hungary usually involved a series of sequential transactions, for example:

1) A joint venture (JV) is founded and incorporated, initially as a shell;
2) The SOE's management unilaterally contributes the majority of its assets to the JV;
3) The JV partner contributes assets worth more than the diverted state assets, thus ensuring its control of the JV;
4) The JV may then commence operations or effect further transfers for "laundering" or business purposes;
5) The state is left with only a minority interest in the active JV, a state company that has essentially become a shell, and the least valuable (residual) assets.[18]

Other methods were also used to secure SOE assets, such as the manipulation of bankruptcy procedures.

While some observers note that spontaneous privatizations were not always corrupt or illegal, these transactions were at best problematic. It was usually not clear that the SOE management had any authority to sell state assets, and it was often unclear to whom the assets were being sold. Also, of course, there were numerous opportunities for managers to profit personally – e.g., through employment contracts with the new entities, and essentially "free" equity. Hence, most such transactions at a minimum presented a conflict of interest (e.g., that management set a low asset value in anticipation of personal profit), if they were not outright theft. Indeed, the proceeds of these sales usually did not go to the state budget but to the enterprise or a subsidiary (and the relevant managers). As one observer commented: "There was no formal liquidation, of course, but the assets would dissipate over time as managers prepared for new lives in a market economy." (Fletcher 1995 p. 49)

Scores of large firms were spontaneously privatized with constellations of firms in holding structures around them – resulting in hundreds of new interconnected entities with both private ownership and (usually) some participation by the state – frequently a controlling block of shares held by an SOE. Some spontaneous privatizations amounted to pure theft or at best created mechanisms for unconstrained rent-seeking. Normally, the state enterprise itself would be left holding the bulk of existing debts and worthless assets. Where the transactions were indeed designed to create an ongoing, at least partially private, concern, cross-shareholdings and interlocks were expected to provide a means to coordinate behavior among the involved companies. This meant, in a sense, perpetuating aspects of vertical integration, soft budget constraints, and informal networking characteristic of the state sector under late communism. Since many such transactions were undertaken in order to forestall bankruptcy or takeover, the corporate groups and networks that came into being frequently combined distressed enterprises with banks, with the latter providing loans in return for shares of equity.[19]

[18] Fletcher (1995).
[19] Stark (1996).

Chapter III: Problem Analysis and Diagnosis

Why did the forms of financial corruption just reviewed occur so pervasively in Hungary at that time? Indeed why have they become a way of life to this day in several less-successful economies? Here, we analyze the abuses discussed in the previous chapter, in Hungary during the early 1990s as well as in transition environments more generally. Our aim is to diagnose the root causes, hence to provide a foundation for the examination of policy responses in the next chapter. We find that the combination of state ownership with extensive corporate networks, and a relatively chaotic and predatory environment, tends to submerge transparent accounts and financing transactions in favor of lobbying and misappropriation. When these factors had gained ascendancy in Hungary, the country faced painful choices about its path ahead, with its future hanging in the balance.

It is worth noting at the start that some care is required in designating and treating the financial abuses reviewed above as corruption. The conventional definition of corruption as "the abuse of public office for private gain" (Klitgaard 1988) usually evokes little controversy in practice. In the present case, however, there is a serious question: Which "public office" has suffered abuse? Certainly, many private parties have reaped substantial gains through underhanded and apparently illicit means. However, "corruption" does not provide an apt description of all wrongs, and must be carefully distinguished from things which are, without more: (a) inefficient, (b) socially disapproved, (c) civil wrongs, or (d) criminal (whether the crime is committed by private actors or public officials acting outside their scope). Corruption entails an abusive public act, a suborning of state authority, resulting in improper benefits for those involved, including those whose acts are clothed with public authority. Thus, theft by a private individual is not usefully described as corruption. Self-dealing or diversion of assets by corporate insiders lies closer to the definition of corruption, since it involves the abuse of a position of trust, a fiduciary obligation towards a "public" comprised of actual or potential shareholders. Corporations are also creations of law, hence to an extent have the state's imprimatur, especially in the presence of state ownership or public subsidies.

If abuses such as self-dealing and diversion of assets involve a bank, then their characterization as corruption becomes still more apt. These activities perhaps most clearly embody corruption to the extent that the bank in question is wholly or partly state-owned, but this is not required. Banks not only are generally corporate in form and publicly held, but they are chartered, regulated in detail, and (at least in principle) closely supervised by the state. Thus, one frequently finds that banking scandals and crises arise from failures of governmental oversight. At best, these might be regulatory lapses, at worst collusion involving political or administrative officials. One example comes from the S&L scandal in the U.S. There, privately-owned banks lobbied for regulatory changes and political interventions that contributed to private enrichment, widespread bank failures, and the need for a costly government cleanup program.[20] An example from the transition countries, the Russian loans-for-shares program (see below), is neatly summarized by Stiglitz:

> The government can allow private entrepreneurs to create banks, which can lend these private parties money with which to buy the enterprises (or in the loans-for-shares deal, lend to the government, with shares of government enterprises as collateral). Whoever got the banking license got a license to print money, and the license to print money is a license to acquire government enterprises. While the corruption was somewhat roundabout – and the process was

[20] Adams (1990).

less transparent than if the government had simply given the nation's assets to its friends – there is in fact little distinction between the two processes.[21]

Especially in developing and transition countries, abuses by companies and banks most clearly entail corruption when these institutions' nexus with the state creates a channel for private interests to extract benefits through the abuse of public authority. The checks that modern statecraft put in the way of such abuse – e.g., legislative and business ethics, regulatory agency independence, company and bank charters, effective systems of corporate governance – have become highly permeable in these situations. In other words, state enterprise or bank managers become the allies or tools of individual ministers and legislators. These entities become politicized. Where this involves official decisions allocating improper benefits to private parties, including the decision makers, we have clearly entered the terrain of corruption.

This too happens at least episodically in the West. For example, in the US, even though the state did not own the banks that failed during the S&L crisis, the politically favored status of these institutions helped create the conditions for their failure and the financial disaster that ensued. Not only did these institutions and their supporters lobby for systems of regulation and deposit insurance that created dangerously perverse incentives, but they also used political influence to ward off regulatory oversight as they slipped into crisis and in some cases to protect themselves from liability after the denouement. (Adams 1990) In other words, the state's economic objectives themselves may usher in governance failures, since the former tend to increase private entities' ability to call on state support and to "hold up" the government.

Ownership Incentives

It would not be an exaggeration to say that the structure of ownership has played the central role in generating the forms of corruption experienced in post-communist financial systems. To clarify, we are not suggesting that the *identity of the owners* (e.g. state versus private) determined all else. Rather, it was the *incentives* embodied in ownership structures that exercised the key influence. Of course, this often is intimately connected to who the owners are, but the distinction is an important one. Other factors also come into play, as discussed below, but mainly to the extent that they shape the content of ownership (property rights) and its exercise (corporate governance and contract).

Ownership holds the key because in well-governed market environments, it provides a structure of oversight and discipline that supports growth – in large part because it imposes elements of transparency and restrains many forms of predation. This is especially so where governance institutions and market competition support the transfer of ownership to more and more efficient owners. By contrast, to the extent ownership structures incline heavily toward either (i) monopoly, or (ii) uncertainty, they will invite abuses by actors within and outside the state, allowing unconstrained discretion and failing to impose accountability. This fits another classic formulation of corruption: *monopoly plus discretion minus accountability*. (Klitgaard 1988) In this situation, the surrounding institutions face severe challenges in attempting to restrain corruption.

[21] Stiglitz (1999), p 5.

Making Good and Bad Owners:

Here, we are concerned with the ownership arrangements that tend to foster the most corrupt incentives. Conglomerate and state ownership have classically presented the most severe governance problems, but many of these also carry over into mixed and privately owned entities, especially in the presence of weak institutions. This discussion touches generally on the issues arising from bank and enterprise ownership structures in emerging economies. The subsection that follows takes up these matters in the specific context of Hungary's transition.

Conglomerates, or financial-industrial groups that encompass both banks and real sector enterprises have a history of problematic governance. Indeed, public concern has grown in recent years, especially following the Asian financial crisis, about the impact of corporate structures on the overall quality of governance and economic performance. Conglomerates are thought to have contributed much to the crisis, for example in Korea, where cross-ownership of banks, investment brokers, and industrial enterprises can quickly spread financial distress and bring a large *chaebol* crashing down.[22] Governance is perceived to be at the root of such problems, with the combination of "crony capitalism" -- featuring corrupt relations among banks, enterprises, and politicians -- and conglomerate structures with narrow capital bases designed to keep control in the family, but vulnerable to external shocks. Inefficient and wasteful investment, based on an artificially low cost of funds, contributes to this vulnerability. In this mixture, corporate boards frequently do not play the monitoring role expected of them in Western countries, but serve more as a mechanism for social networking.

Increased awareness of the potential costs of conglomerate ownership, and consequent weak corporate governance, is pushing change. The aftermath of the Asian financial crisis, for example, has brought about new company legislation in Thailand and calls for strategic foreign investment in Malaysia. In Korea, bank lending to the *chaebol* has decreased, while credit and equity investment in small, non-affiliated firms has grown remarkably. This search for solid gains and strong corporate governance appears to be fuelling much of the capital flight from the "old" to the "new" economy in Japan and Korea.[23] Even in Germany, starting in the mid-1990s, several collapses and near-failures involving bank-owned companies convinced leading banks to begin moving toward an arm's length investment posture, and away from the financial-industrial group model in which the banks attempted to guarantee stability (including protection against takeovers).[24]

With respect to state ownership or control, the "grabbing hand" perspective contends that this should always be kept to a minimum, since the state is virtually always a bad owner:

> [N]o matter what smoke and mirrors are used, as long as the government remains in ultimate control of enterprises, which it does by definition in all market socialist schemes, its objectives are going to be the ones that are maximized. Any manager who dares to stand up to the government, or to the bank controlled by the government, will be acting against his personal interest. Similarly, no manager of a bank controlled by the government will refuse to lend money to a large state enterprise when the government that hired him "advises" in favor of the loan.[25]

In this perspective, state-owned enterprises and banks are driven by the same pathologies as the legislative and executive branches: principal-agent problems, collective action failures resulting

[22] "To the Brink, and Back Again," *The Economist*, June 3, 2000.
[23] Plender, John, "Weeding Out Corruption," *Financial Times*, April 25, 2000, p 16.
[24] "European Business Survey," *The Economist*, April 29, 2000.
[25] Shleifer and Vishny (1998), p 129.

in the triumph of narrow interests, and tyranny of the majority. (Shleifer and Vishny 1998) The performance of state commercial entities around the world, including SOEs as well as state property agencies, seems to confirm the difficulty of ensuring that they perform in a market-oriented manner. They usually have multiple stated objectives, many of which are incompatible with efficiency and competition, and the inevitable discretion that state agencies exercise as owners makes it difficult to hold such agencies to democratic administrative accountability. Last, state holdings of significant size usually translate into two forms of informal influence: by the state on enterprise management (and, indeed, on its market sector generally), and by private actors lobbying for beneficial changes in state policy (including privatizations in which they may have an interest in participating as investors). (Pistor and Turkewitz 1996)

Box 3
Studies of Finance in Conglomerates and State Institutions

Recent findings from research illustrate the difficulties that financial-industrial groups and state-ownership pose to effective financial governance.

In the former case, an empirical study of nearly 300 financial institutions across East Asia looked at the problems of conglomerates. It found that some 42 percent of financial entities experienced distress after July 1997, and 13 percent of the institutions in existence at that time had been closed by July 1999. Based on 1996 financial data, it was determined that connections with industrial groups or influential families increased an institution's probability of distress and closure, while an institution's size increased the chances of distress but made closure less likely. Interestingly, foreign ownership decreased the likelihood of distress and closure. (Bongini et al 1999) This suggests a directly negative influence of conglomerate structure on corporate governance, and less pervasively on prudential supervision. Another empirical study suggests that weak corporate governance in certain East Asian countries resulted in increased theft and self-dealing by managers as firms' economic prospects deteriorated early in the crisis. This in turn led to a larger fall in asset prices in those countries with weak corporate governance (e.g., Indonesia and Thailand) than in other countries (e.g., Hong Kong and Singapore). (Johnson et al 1998)

Studies of SOCBs demonstrate comparable problems in state institutions. A study of state-owned banks in Bulgaria (during the period 1992-7) suggests that ambiguity in the delineation of ownership rights helped create moral hazard and undermine efficiency, and that the government's credit policies toward the enterprise sector weakened prudential standards, thereby contributing to the financial crisis of 1996-7. (Dilova-Kirkowa 1999) Indeed, in Bulgaria, it has been found that the main beneficiaries of long-term credit during the 1993-5 period were large firms with *negative* cash flow. (Budina et al 2000) In China as well, after 20 years of reform, the allocation of financial resources by the mainly state-owned banking system is heavily oriented toward the declining state sector and overlooks the growing importance of the private sector. In the early 1980s, China moved from budget allocations to (state) bank loans as the chief means of financing SOEs. However, as the profitability of SOEs declined in the mid-1990s, SOCBs were often forced to extend new "policy" loans to inefficient SOEs at controlled interest rates. The Chinese banks were recapitalized by government in 1998, but at the same time the central bank dictated artificial limits on adverse loan classifications by the SOCBs (e.g. no more than 8% could be "doubtful"). This effectively hid the bad loan problem from view, preventing a real solution. (Bonin and Huang 2000)

Government ownership of banks has been viewed with greater ambivalence, although it is increasingly clear that this can lead to major problems of governance. The "development" or "commanding heights" view looks on state ownership as a means of resolving a market failure, where private banks are not sufficiently developed to channel savings into long-term industrial development. The competing "political" view holds that governmental control of financial institutions politicizes resource allocation (i.e., directs credit to favored entities, sometimes in return for bribes to politicians), softens budget constraints, and lowers economic efficiency. An analysis in 1999 of the performance of nearly 1,000 large banks across 92 countries showed that government ownership of banks is pervasive, with an average of 48 percent of banking system assets controlled by government (61.8% in formerly socialist countries) – much higher than government participation in general economic activity. Cross-country regressions reveal that increased government ownership of banks is associated with: (i) lower overall quality of government (i.e., greater intervention in the economy, lower efficiency, less legal security, higher incidence of political and financial crises); (ii) more restricted political rights; (iii) worse bureaucratic performance and higher corruption (though the latter is affected by income levels); (iv) slower productivity growth and financial development (subsequent to state intervention in banking); (v) misallocation of resources (lower proportion of credit allocated to firms outside the top 20 and higher interest rate spreads); and (vi) lower overall economic growth. (La Porta et al 2000)

Other observers take the view that ending state ownership is not the answer to every transition problem, and that several "private" ownership arrangements are in fact even less desirable. Merely moving ownership from the state to non-state owners, in and of itself, is a small accomplishment, given that it can be done more or less immediately by giving state assets to friends and cronies (which has frequently happened anyway). Even the more sophisticated argument that companies and banks should be privatized in a way that yields a "controlling" owner breaks down when, for example, the owners are investment funds whose material interest in the improved value of any given company is minuscule (e.g. 0.4% in the Czech voucher scheme). In other words, aligning interests among management, major shareholders, and the owners as a group appears to be the critical factor. Dispersed ownership discourages collective action by owners to monitor and control managers. More concentrated ownership can supply the missing incentives here. However, there is also an important caveat: this could lead to collusion to oppress minority shareholders and misappropriate value if the framework for corporate governance is weak. (Zhu 2000) Indeed, as we have hinted and will discuss more fully below, legal ownership may count for little where it is not supported by an array of enforcement institutions, or protected by stable constraints on the exercise of factual control by non-owners.

Ownership Flux in Hungary's Enterprise Sector:

In Hungary, as elsewhere under communism, enterprises in effect were administrative arms of the state. The pre-transition SOEs are said to have had three separate holders of control rights: (1) the paternalistic party leader, (2) the party and state bureaucrats, and (3) the on-site manager. These actors did not abandon their roles immediately when communism fell, but tried to influence economic transition outcomes, especially in banking. Many of the conflicts and distortions during privatization can be explained by this dynamic. For example, the managers of small SOEs tried to become owners. By contrast, the managers of large SOEs could not become owners outright, given the attention these firms received from policymakers. As a result, they tried to guarantee their autonomy (and the benefits flowing from that) by postponing privatization as much as possible, and attempting to choose their own owners or bosses. The chaos of transition offered these actors opportunities to position themselves well in the emerging private economy, to guarantee themselves a comfortable retirement, and/or to seize unprecedented opportunities for enrichment.

During the 1980s, Hungary had experimented with several different ownership and company forms. One of the reforms enabled state-owned firms to restructure themselves and create new firms on the basis of existing assets. This reform in essence extended a right previously given to workers, to create partnerships and use the assets of their state firms in their private work, to enterprise managers. Managers seized this opportunity to extend their power and control, fracturing firms into many pieces and creating intricate networks among firms. Many

SOEs became holding company structures and state officials had a very difficult job tracking all of the changes and networks. Within the holding company structures, managers had wide latitude to shift assets back and forth between closely-held firms. In addition, one of the last communist-era reforms, the Company Law[26] of 1988, provided a legal mechanism for SOE management and others with political connections to engage in spontaneous privatizations, by incorporating private entities – to which they then diverted state assets. These deals were commonly ratified by Enterprise Councils, formal SOE governing bodies that exercised the only effective property control functions at the time, and were in any event controlled by the management.

Such transactions enabled SOE managers, in effect, to translate political into economic capital, and in so doing, to choose their preferred private owners (including, to the extent possible, themselves). At a higher level, senior *apparatchiki*, party officials, and others close to the top appropriated state property (e.g., houses and office buildings) for themselves, and plundered the assets of the Hungarian Socialist Party. Not only were government auditors expected to overlook these activities, but the roundtable agreements that brought about democratic elections are understood to have bound the first post-communist government to overlook these abuses and the material riches they brought to members of the old elite. This included tolerating their continuation, in the form of further asset-stripping, misappropriation from state budgets, and rigged auctions – and the recycling of the resulting funds and assets into private foundations as conduits for political campaigns. Much of this, in a sense, was the price of a "negotiated" transition from communism, enabling managers to become CEOs or owners or both, and providing the senior elites a sizeable nest egg for their retirement.[27]

The extensive cross-ownership resulting from these activities produced a structure that was murky, incestuous, and collusive. This led one critic to call this stage of transition "a shift from plan to clan." (Stark 1990 p 374) Spontaneous privatization continued after the SPA was established but the latter helped control abuses by arranging and approving sales. The initial privatization programs have been considered failures. It is indicative of the problems that a subsequent program in 1991 took as its objective sorting out some of the improprieties and fallout from the early privatizations, but this too proved to be a failure.[28] The confusion created by these ownership networks is aptly described as follows:

> Local councils, ministries, cooperatives, enterprise councils, and individuals often had indistinct ownershiplike interests in specific assets. For the Hungarians, beginning to privatize was a bit like starting to set up a garage sale and realizing that one was not sure to whom all those items in the garage belonged. The Hungarians solved that problem by calling virtually all state-controlled property "state property" and leaving for another day the question of how to divide the proceeds of its sale.[29]

The government's early attempts to manage the process themselves contributed to the problem. For example, it transferred several hundred firms to municipalities in 1990 -- as a result, privatization of major utilities was delayed until 1995 due to confusion over who owned what.[30] In 1988-9, the government opened the country up to foreign direct investment (FDI) by passing legislation on joint ventures, foreign investment, and corporatization of SOEs. By this time, spontaneous privatizations had begun; foreign investors soon joined in, for example in the Tungsram and IBUSZ deals. Fair and full valuation of the state assets contributed to these deals

---

[26] Act VI of 1988 on Economic Associations (Companies Act).
[27] Stark (1990), Tokes (1996)
[28] Fletcher (1995).
[29] *Id.* p 37.
[30] World Bank (1998)

posed a difficult problem, and few onlookers felt confident that state assets were not simply being "given away." The government, favoring privatization and not willing to interrupt these changes, adopted a policy of non-interference, thus enabling enterprise managers to privatize their firms in a legal and policy vacuum, a kind of free-for-all. Problems arose because essentially no one was monitoring these managers.[31]

Thus, Hungary's early efforts did not yield the kind of private ownership structure that could support, or operate in, a competitive and transparent marketplace. One might summarize this situation by saying that early transition ownership structures in Hungary combined all the private enrichment opportunities, and all the public governance nightmares, of both conglomerate and state ownership. In a sense it was worse than this: networks of ownership and control were sufficiently murky that the factual role of state and private actors in them was virtually unknown to anyone but insiders. These relationships are diagrammed in Figures 1 and 2: the first depicts the early moves away from full state control, and the second presents relationships arising within the resulting mixed ownership structure.

Weak Incentives and Governance in Hungary's Banks:

Similar issues of weak ownership incentives arose in Hungary's banking sector. This, again, was due to a combination of complex holding structures (often involving the state, enterprises, and other banks) and the fact that bank ownership remained largely in the hands of state agencies. These state owners tended to be either inattentive, politically motivated, and/or venal. The feeble nature of bank regulation and supervision at this early stage meant a near absence of effective monitoring and accountability.

Hungary had formally dismantled its communist-era banking monopoly in 1987, creating a commercial banking system out of the dissolved monobank. The three newly-created banks were given a portfolio of loans and an established clientele (mainly SOEs, whose relationships with the banks have been described as "cozy"). Bank debt was significant, given the government's long-standing problems with borrowing and the willingness of the government to extend domestic loans in order to boost hard currency earnings. Most firms needed more credit to survive, and many SOEs were also major shareholders in the banks, which meant that cutting them off from new credit lines would be implausible. The 1987 reform allocated existing SOE loans and clients by sector, all of which were in bad shape. The commercial banks were organized to serve these specific sectors and allotted $670 million in bad loans (but by late 1991 their aggregate capital was only $480 million). In 1992 the state directly owned 35-40% of all bank shares, with the rest primarily owned by SOEs. Overall, bad debt in 1992 was estimated to have ballooned to a total of some $1.2 to $3 billion, with over 20% of all loans considered "high risk." (Fletcher 1995) The financial system had become perilously shaky.

Not surprisingly, these patterns of state management and the emerging mix of ownership failed to produce effectively governed banks. Bank officers were expected to extend and to monitor performing loans essentially as they had under the communist monobank system. In the environment of flux and crisis during the early 1990s, the relative scarcity of cash and credit appears to have led to a severe form of rationing in which political considerations – allocation decisions made at high levels in the state banks or imposed on them due to the importance of a given SOE – clashed with economic considerations and new laws coming into force. The government was desperate for cash in the early 1990s, and its frequent emission of bonds soaked up most available bank capital. Furthermore, the banks began negotiating recapitalization

[31] Fletcher (1995).

programs with the government in 1991 (see below), thus further undermining their incentives to extricate themselves and compete for profits. The belief that the government was going to buy up the bad debt of banks (thereby relieving banks of their bad debts at the same time firms were released from their obligations) strongly influenced bank and firm behavior. Frequently, instead of working to decrease their bad loan portfolios, banks attempted to maximize the proportion of their questionable loans that they classified as bad.

Corporate governance and oversight were in practice too weak to counter corrupt practices in banks (or in enterprises, for that matter). The government placed state officials on bank boards in theory to exercise state control rights, but in practice to reward them with an opportunity to collect an extra salary. Bank management was connected to the political powers and controlled everything – an exercise of power that enabled them to enrich themselves and, in effect, to defer privatization. Uninformed bureaucrats representing the state on the bank boards could not have changed this even if they had wanted to. Not surprisingly, control of the banks became an object of political competition. The rightists under the Antall government were said to have controlled MHB, and the socialists to have controlled Postabank and K&H Bank under the Horn government. On the other hand, it does appear that, despite contrary pressures, the banks (or perhaps some banks) had by this time begun to exercise financial discipline and to reduce their outstanding loan positions. There is evidence that the banks were not just pouring money into the worst clients in an effort to save them ("sending good money after bad") but in may cases stopping credit flows to non-paying debtors.[32] Along with legislative reform, recapitalization, and restructuring efforts, some attempts were made to put the banking system's "crooks" in jail, but these were largely unsuccessful.

Lastly, the complexity and non-transparency of real sector ownership structures exacerbated the banks' weakness and helped undercut financial discipline. Due to these confused ownership arrangements, even the most advanced banks would have had enormous difficulties determining the creditworthiness of their existing clients and evaluating potential customers. It was difficult for the banks to determine the capital base of a particular firm, and the fluid boundaries that existed among firms made asset transfers very easy to arrange and manipulate. A large firm one day could become a small firm the next without much effort. Neither the state nor the banks could do much about this at the time. This might have happened even where the affected creditor bank had the ideal ownership structures and incentives (but the debtor enterprise did not). Here, the discretion of others, including the state and the relevant firm, is given free rein in the absence of institutions providing effective disciplines in the form of corporate governance, information disclosure, contract enforcement, bankruptcy, and state administrative oversight. We take up these institutional matters more fully below.

Constraints to Reform

To complicate matters further, Hungary's early transition environment imposed significant constraints on reform, i.e. constraints that both made reform difficult *and* limited the likely impact of certain reforms. One obvious factor was the deep economic crisis of the early 1990s. This threatened most enterprises with failure and created conditions for a huge buildup of non-performing debt, which had to be addressed before any serious reform could succeed. A second, more subtle factor was the ownership structure of most banks and firms, discussed above, which tended to undercut efforts to strengthen governance by improving legal and regulatory institutions. We take up the latter point first.

[32]Bonin and Shaffer (1995).

The Limits of Law:

As has been suggested, formal ownership counts for little in the absence of institutional supports and protections, and financial transactions especially depend on them. However, there is a sense in which the ownership relations among the public, enterprise, and financial sectors – hence the actual governance of most economic activity – determines in advance the importance of relevant institutions such as laws and regulations. In any business environment, the state, the financial institutions, and the enterprise sector form a triad in which the relationships among these sectors dictate particular mechanisms of coordination among them. Thus, for example, if both the financial and real sectors are wholly owned and controlled by the state, then coordination would be essentially hierarchical and administrative, as it was under Stalinism. By contrast, combinations of two sectors (state-finance, state-enterprise, enterprise-finance) would tend to exercise significant, if not predominant, power over the third sector. Examples of these would include state development banks, strategic state-owned enterprises, and large financial-industrial groups. The combinations essentially coordinate their behavior as a matter of policy (in the case of financial-industrial groups, there may also be a family or other social basis for this), and the third sector may have little *de facto* power to influence these relationships. Alternatively, the third sector (e.g., government, to continue with the previous example), may be "captured" by the sectoral combination, perhaps through social networks or patronage, perhaps through bribery or other forms of influence-peddling, and hence it in fact has no interest in restraining the more powerful combination.

In other words, transition (as well as development) exhibits a certain path-dependency: ownership networks created early on appear to constrain the effectiveness of even the best-designed legal and regulatory institutions. Of course, inherited social norms and relationships can also inhibit the influence of formal institutions, and indeed of the rule of law itself. In transition countries, law-based economies would have to emerge from a pre-existing system of hierarchical command interlaced with informal social networks based on status (e.g., membership in the Communist Party), regional origin or locality, membership in a criminal gang or mafia, and perhaps to a lesser extent ethnicity or kinship. Alternative networks grew informally and became critically important to survival under late communism. Privatization, whether formal or spontaneous, may have resulted in numerous enterprises and banks being owned and managed by former *nomenklatura* members, some with strong criminal ties.

In this situation, the writ of neither law nor managerial discipline extends very far. Banks' relationships with major enterprises carry over from the communist period, when these banks formed part of the state structure and developed a frequently tight mutual dependence with the SOEs that have now become, in theory, their "private" banking clients. Empirical surveys suggest that past members of the Party hierarchy have easier access to bank credit than others. The fact that few banks have the technical capacity to evaluate applicants from beyond the pool of established ex-SOEs, and that many are at least technically insolvent, only increases large-enterprise leverage over the banks.[33] Massive portfolios of non-performing loans have severely limited the options of most commercial banks in reorienting their lending practices and modernizing their operations. Also, from the banks' perspective, information asymmetries appear extremely difficult to overcome. Trust is frequently low, reliable accounts are difficult to come by, and credit rating largely non-existent. Banks prefer to sift among the better-known firms in order to find their borrowers, and here they can set loan prices with some confidence.[34] Thus, one

[33] Gros and Steinherr (1995)
[34] See Baer and Gray (1996).

could think of weak governance in post-communist financial systems as both an outcome of, and a reason for, the failure to create an economy based on market incentives and legal relations.

Setting aside the finer tactical issues of sequencing, there appears to be no choice in most transitions but to move on both the ownership restructuring and institutional reform fronts more or less simultaneously. Hungary did so. Spontaneous privatizations and joint ventures coincided with gradualist programs of formal corporatization and divestment, the dismantling of banking and production monopolies, and the reform of a host of governance institutions. These reforms touched both central aspects of the rule of law -- such as the constitution, court systems, public administration, and oversight bodies – as well as key institutions of commerce and banking. Several of these changes were in place by 1991, including the reformed Company Law mentioned previously. During that year, it became evident that Hungary needed institutional reforms that would address three critical issues in the governance of the financial system: the failures of financial discipline referred to collectively as the soft budget constraint, the lack of reliable information on company performance and accounts, and the absence of a credible information base and organizational structure for overseeing the banking system. The legislative initiatives aimed at addressing these problems will be analyzed in the next chapter. For now, it suffices to say that these formal changes in law, regulation, and organization failed in the near term to counteract the corrupt incentives driving most banks and enterprises to behave in the ways reviewed in Chapter II. Apart from the flaws in these reforms themselves, the more important point is that other fundamental conditions needed to be in place before the reforms could have the desired effects.

Governance and Reform Under Crisis Conditions:

A shrinking economy – a given of early transition in Hungary as elsewhere – can itself create incentives towards corruption. It can create pressures for firms, banks, and officials (e.g., regulators and tax collectors) to accommodate economic distress by colluding to avoid application of the laws. It can also encourage officials to supplement declining real public sector wages through bribery, misappropriation, self-dealing, and other forms of corruption. Last, economic crisis pushes individuals and firms into participation in the informal economy, with the various forms of asset-diversion and extortion that this entails. All of these strategies became more likely to foster corruption as a result of the political and social repression imposed by communism, which left few real restraints on corruption in the initial period of transition. (Tokes 1996, p 413-4)

The early transition crisis in Hungary drove most firms and banks to the brink of insolvency, and frequently beyond. At the end of the 1980s, Hungary had one of the largest public sectors in world, as well as a largely stagnant economy depending for fully 40 percent of its earnings on Soviet bloc (COMECON) trade. Thus, the most serious economic downturn came with the disappearance, practically overnight, of Hungary's eastern markets with the dissolution of the USSR in 1991. Many SOEs saw their major business dry up, and fell into desperate straits, unable to pay back loans being called by the increasingly shaky banks. Hungary's "legislative shock therapy" (see discussion in the next chapter), coming at the same time, made matters worse by imposing very strict financial discipline and transparency rules during a deepening crisis. The number of insolvencies spiked, but coping strategies managed to put off the day of reckoning for some and allow others to recover. These strategies apparently included rolling loans over, misreporting accounts, misclassifying loans, extending some new credit, and informally "queuing" arrears on inter-enterprise debt (i.e., creditor firms sending receivables to their banks, where they would wait in turn for insufficient funds to be replenished and payment to be effected).[35]

Thus, Hungary's transition crisis did much to help create the complex interweaving of state and private ownership interests, carrying on from the market socialism experience in the 1980s.[36] The interaction of late-communist banking reform with the severe economic downturn of the early 1990s landed the banks in a very weak position, while the enterprise sector was suffering from recession and failure at about the same time. Loans continued to be extended and rolled over, as the debt burden mounted. Inherited incentives in the banks and firms, along with weak surrounding institutions, made possible the variety of corrupt and self-dealing arrangements reviewed in Chapter II. A component of insiders' motivation (in both banks and enterprises) was the evasion of responsibility for non-performing debt, and frequently the leveraging of self-interested transactions that in effect both increased the debt and reduced the base of assets available to generate funds for repayment. These evasions and misappropriations often required transfers of funds and physical assets across corporate networks, thus adding further to the complexity of holdings in the financial and real sectors. Thus, the crisis appeared to have the potential for blocking reform by making it difficult to implement change without deepening the crisis, and by strengthening hidden networks of anti-reform constituents.

Policy Choices

What choices did policymakers in Hungary face in grappling with these problems? Clearly, the widespread manipulations that kept financial lifelines open to connected firms indicated the need for massive restructuring and a return to financial discipline. Restructuring, in turn, would require hard budget constraints and the introduction of market incentives. Most firms in transition environments try to restructure if their avenues for rescue are closed off and competition increases. Shrinking subsidies and open markets lead to labor shedding and/or falling real wages, sales of excess inventory and assets, more aggressive collection of receivables, and reorientation from communist-style output targets to profits. Tax arrears are the most difficult "subsidy" to eliminate.[37]

Some degree of enterprise privatization, or at least insulation from political decision making is critical – for profit-oriented firms as well as for healthy banks. The key steps here are usually thought to be (1) corporatization, or turning day-to-day control over from political officials to managers, and (2) reducing cash flow ownership by the treasury and increasing cash flow ownership by managers and outside shareholders. Thus, privatization in principal widens the separation between managers and politicians, and so stimulates restructuring. This helps to cut implicit soft budget constraints, making politicians thereby publicly accountable for imposing distortions on firms, such as excess labor spending. Policy directives and subsidies are more overt, as well as more expensive, than the prior mechanism of allowing SOEs to avoid remitting profits to the treasury. Ownership by large outside investors who care less about political objectives such as the level of employment is better still (in terms of efficiency), since investors

[35] Bonin and Shaffer (1995).

[36] While many analysts consider corporate and banking networks in Hungary to be unprecedentedly complex and murky, others suggest that networks have never been as big a problem in Hungary as elsewhere, e.g., Poland, and the former Czechoslovakia.

[37] There is evidence that tax arrears represent the "softest" part of the soft budget constraint: for example, in Poland and Russia, central subsidies were dropped, but local ones grew as enterprise layoffs were deferred and employees kept on. World Bank (1996).

are even harder than managers to convince through subsidies, and they are farther from having any shared interests with politicians. Thus, large outside shareholders promote restructuring for profits.[38] Removing political control from large firms also means that they are not an effective means of political influence over the banks. Obviously, a host of speed and sequencing decisions need to be made here. However, governance considerations broadly suggest that careful, deliberate restructuring and privatization of major enterprises is best where feasible, with parallel efforts devoted to building supportive legal and regulatory structures.

What policy choices were available for reform of the banks themselves? One of two general approaches could be taken:

(1) to place the highest priority on competition and innovation, by liberalizing the entry of new banks, and by encouraging the breakup or liquidation of the SOCBs (the approach taken in Estonia and Russia);
(2) to focus on the rehabilitation and recapitalization of existing banks (the approach taken in Poland, and indeed in Hungary).

The first approach seems particularly apt for poorer countries, since it enables rapid banking sector growth—but confidence could easily be undermined by widespread poor bank quality, volatility, and bank failures. The second approach helps maintain greater confidence and stability in the system, but also keeps a large role for SOCBs, which can increase moral hazard. This approach also makes it centrally important to have a coherent policy for dealing with problem banks – e.g., to stop flows to insolvent banks, to require that management be changed, and/or to ensure that private shareholders bear the costs by losing their stakes in liquidated or restructured banks. (World Bank 1996)

At this point, it may seem paradoxical that the most effective measures available to combat the forms of financial corruption presented above may not be *anticorruption* policies *per se*. In the Hungarian transition, the best policy was not necessarily to *attack* corruption at all—since it is a symptom of a more deadly underlying disease—but to treat the disease itself. This should not be taken too far, since anti-corruption rules and agencies, along with institutional checks and balances and watchdog organizations, have an important role to play and merit close attention. However, the focus of policy decisions (hence of this case study) must of necessity be on diagnosing and treating the underlying structural malady. We could describe the malady as one where: (i) opportunities for gain through rent-seeking and theft outnumber those available through production and market-based competition, and (ii) benefit/risk comparisons consistently favor the former. This problem is classically associated with situations of flux – regime change, rapid economic development, or in this case, post-socialist transition. The communist state in most respects was a tool of the party elite, and has become in many cases the tool of a succeeding elite (and the two are not necessarily mutually exclusive). Further, the social, administrative, and economic chaos attending most transitions has paved the way for mafias to enrich themselves, cornering the market for such post-socialist amenities as security services, bureaucratic fixing, and informal credit.

[38] Except, as in Russia, where politicians created state holding companies to become core investors in privatized firms, which increased political influence on the firms; or more subtly in Poland, where government-sponsored mutual funds became controlling shareholders in privatizing SOEs, but tended either to represent the preferences of politicians over profits, or not to exercise effective governance at all. Shleifer and Vishny (1998).

This discussion suggests that strengthening governance and curbing corruption in transition countries involves not only building effective state institutions, but also several further tasks that are extremely important and difficult. Corporate governance in transition environments takes on special importance, and is closely linked to public sector governance and the dynamics of "state capture."[39] The same is true of market institutions such as commercial laws. In both cases, the objectives of institutional reform include the protection of private sector actors from state (or state-related) predation, as well as the converse: the channeling of private sector incentives away from a primary focus on lobbying and cronyism, towards profit based on market competition. The extent to which the corporate and market institutional regimes become self-enforcing by the parties, and hence squeeze third-party (including state) discretion out, will in large measure determine the market's insulation from politics. A related task is to ensure that these institutional mechanisms, as well as the political process, ease the less adaptive members of the old *nomenklatura* out of the state and the private sector as well.

It is important to bear in mind that, in the early stages of transition, a frontal assault on the types of corruption discussed here may in fact be counterproductive. If the market structure and the rule of law are no more than embryonic, then such a campaign is likely to prove wasteful at best, since the overriding incentives towards corruption remain in place and the restraining mechanisms have yet to be built. This could also divert scarce attention and resources from structural economic reform, and in the process foster cynicism about restraining corruption. Worse, anti-corruption initiatives may end up strengthening the hand of powerful interests in the state and the private sector who aim to subvert reform and competition.

Lastly, it is often difficult in such an environment to say how any sensible reform could actually come about. Politicians rarely want to relinquish control of firms and banks once they have it (unless the political gains are large enough or the personal benefits are greater than before, e.g., through payoffs to avoid costly excess employment or regulatory "hold up"). Especially where reform has been delayed, powerful lobbies can mobilize to block reforms. Yet, for privatization to maximize sales revenue and restructuring, it must entail several steps that run directly counter to such narrow interests: (i) the surrender of control by politicians; (ii) rapid progress towards deregulation and a legal framework capable of enforcing discipline and constraining predation; and (iii) the selection of SOEs for privatization that have a real prospect of competing and earning profits in the private sector (instead of setting up private monopolies or continuing to require state subsidies). (Shleifer and Vishny 1998) Frequently, all this must be done while the democratic political order, the rule of law, the liberal economic regime, and the business-oriented constituencies for a competitive market framework are all embryonic. If reform fails, the results could be disastrous.

The Stakes: A Cautionary Detour into the Russian Transition

Hungary's experience at this time was typical of the post-socialist transition countries in Central and Eastern Europe, and starting somewhat later, in the former Soviet Union. The region furnishes several examples of alternative approaches Hungary might have chosen, and the consequences. It might, under the influence of an entrenched old-style elite, have taken the path of putting off reform as long as possible, then making gradual changes – as in Ukraine and Bulgaria until 1996. This approach abetted large-scale theft in Ukraine, and contributed to the financial crisis in Bulgaria that helped bring in the present reformist government. The diametrically opposed strategy, of focusing efforts on rapid mass privatization while institutional

[39] Hellman et al (2000).

reform moved on a slower track, provided what appeared to be some quick benefits amid the pain of restructuring, but has more recently shown itself to be deeply flawed. The Czech experience with mass privatization through voucher auctions, from 1991 to 1994, shows the potentially negative impact of this approach for corporate and financial governance. Fragmented corporate control (mainly by voucher funds and banks) allowed insiders and fund managers to extract value from the companies through a variety of tactics. These included murky deals among corporate networks to shift assets and revenues, illegal stock transfers, share price manipulations, violation of prudential regulations, and "tunneling" [40] out of funds and assets through a bank or shell company.[41] This history helped lay the groundwork for bank crises, scandals, and large bailouts.

Russia provides the most dramatic and well-documented example of rapid privatization fueling an explosion of corruption at a time of economic and political chaos. It therefore furnishes an instructive comparison, to illustrate not only that the problems Hungary experienced are far from unusual, but also how much more severe they might have become had they not been addressed. Russian privatization took place in a near-vacuum of corporate governance, making it virtually impossible for outside shareholders to monitor and control company management. This created opportunities for all kinds of self-dealing and other abuse.

The abuses began with the mass privatization programs. Powerful managers, along with their politically favored labor forces, had to be "bribed" with distributions of cheap shares to win their backing for privatization. Moreover, voucher auctions appear frequently to have been manipulated (through logistical arrangements such as holding auctions unannounced or in distant places, or through direct deals with government) in order to keep potential bidders from participating, and to maximize the equity that could be acquired with the vouchers held by insiders. Typically, firms ended up with 60-65% combined management and employee ownership, virtually guaranteeing effective manager control, with the remainder divided about evenly between private investor (or voucher fund) and government ownership. As a result, state control was frequently replaced by insider control. The insiders were able to loot individual companies as well as pyramidal corporate groups that they controlled through linked insider shareholdings. This apparently made outright asset-diversion and "tunneling" out of revenues possible, in addition to other schemes.

Once some of the more powerful corporate insiders had amassed sufficient wealth, many moved on to acquire banks. The Russian banking system had serious flaws from the start of the transition. The laissez-faire entry policy, including extremely low capital requirements and minimal supervision, resulted in an increase from less than 10 to over 2,500 Russian banks in the early 1990s. Many of these were simply "pocket banks" that managed enterprise cash flows, while others developed into Ponzi schemes, and the larger banks cultivated political support – both by virtue of the oligarchs' presence in the policymaking process and through media ownership links. Many used balance-sheet gimmickry to show acceptable portfolios, provisions, and reserves. Russia's liberal entry rules placed few effective restrictions on acquisition or founding of new banks. The emerging "oligarchs" or "kleptocrats" thus had little trouble expanding their empires using banks – as in the cases of Oneximbank and Bank Menatep.[42]

---

[40] I.e., "the transfer of resources out of a company to its controlling shareholder (who is typically a top manager)" through such means as theft, fraud, self-dealing, share dilution, and other financial transactions that benefit the manager at the expense of minority shareholders. (Johnson et al 2000, p 3)

[41] Black et al (1999), Stiglitz (1999).

[42] *Id.*, Perotti (2000).

As a major channel of exchange between oligarchs and politicians, the banking system provided a convenient mechanism for both groups to direct the flow of riches. The notorious "loans for shares" program is the single biggest example. The Russian government, needing to raise revenue but finding it difficult to sell stakes in major enterprises excluded from voucher privatization, arranged the program with leading Russian banks. Under this scheme, the government "auctioned" its shares in strategic companies (e.g., in the petroleum, metals, and telecom sectors) in return for loans from those banks willing to lend the largest amounts against the security of the state's shares. The banks were at the same time put in charge of the auctions, which were rigged in favor of banks with important state and oligarch connections. As (apparently) expected, the government defaulted on the loans, thus forfeiting its shares to the favored group of banks – in effect, a sale of major stakes in the strategic SOEs at a fraction of their real value. (Black et al 1999)

Another enrichment strategy for the banks (and their allies in government) was to arrange for these banks to hold government funds for a fee and at little or no interest – with inflation in the double or triple digits, and treasury bills and money market instruments earning 20-30% real interest. This further enriched banks such as MOST, Alpha, Menatep, and Oneximbank. These banks continued to engage in insider dealing and asset-stripping that came more fully to light when numerous banks failed during the ruble crisis of 1998. These failures provided still further opportunities for insiders to steal, as in the case of Khodorovski, who controlled Menatep Bank – he apparently transferred the bank's good assets to a new bank and helped insure himself against accountability to government and creditors by arranging for most of the bank's records to disappear. (Black et al 1999) In the 1998 crisis, poor lending, often to connected parties, accounted for over one-third of capital losses according to independent audits, and the aggregate share of acknowledged bad loans was 42 percent. As one observer put it:

> …both the banking system and the public debt market developed gradually into two huge financial pyramids, where financial inflows leaked out as capital flight while leaving behind a pile of liabilities and empty boxes. [43]

These accounts reflect the severely distorted incentives of banks, enterprises, and officials. In such an environment, those effectively exercising control in the economy discover that a "self-dealing strategy" pays off much better than a "value creating strategy." Earning a profit in business at best requires entrepreneurial skill and energy, which are not evident in the backgrounds of Russia's kleptocrats. Worse still, the Russian environment of legal uncertainty, corrupt administration, and criminality make profitability both difficult and often undesirable as corporate objectives. Earning more cash than the minimum necessary is expensive, in that it potentially draws the attention of the (often overreaching) tax authorities, criminal organizations, and corporate takeover interests. Arguably, this intensifies the adverse selection problem in credit markets, with stronger firms that seek to finance less risky projects preferring to forgo the added risk of applying for bank loans. (Meyendorff 1998)

Rather than increase company profits, it is more cost-effective to use any means available to enrich oneself, to build networks (including political connections) that enable even more accumulation, and to move these earnings into secure safe havens. Thus, an insider with a minority shareholding is much better off stripping the value of a firm being auctioned in a privatization program or bankruptcy sale, and paying bribes to avoid prosecution or tax liability. This strategy ensures both maximum gain and minimum risk – as opposed to the uncertainties involved in fulfilling one's bargains and then attempting to enforce contractual obligations on

[43] Perotti (2000), p 4.

other parties, declare profits, and pay only those taxes that are legally due. (Black et al 1999) Among the larger enterprises, the rent-seeking part of this strategy meant lobbying officialdom to supply special benefits and to block reform. Too-rapid privatization created the initial conditions, as it did not permit parallel changes in corporate governance, effective restraints on insider abuses and corruption, development of market rules, and incentives that would encourage firms to restructure. This, in turn, helped create a class of kleptocrats who have little interest in restructuring and much more to gain through self-dealing, theft, and corruption:

> In a vicious circle, dirty privatization also reinforces corruption and organized crime, as the new owners (some already with Mafia ties) turn their new wealth to the task of bribing judges and government officials. Corruption and organized crime then reinforce a culture in which inside dealing is the norm. Corrupt officials and company insiders then join forces to resist future reforms.[44]

Of course, the "self-dealing strategy" immediately carried over from the enterprises into the banking system, where investment capital and deposits have been subject to expropriation through both insider manipulation and confiscatory rates of inflation – thus further undermining the business environment and encouraging still more venality in government. The political influence of the Russian banking lobby produced several notable results. Some banks gained profitable government business such as holding state cash balances while earning interest or even speculating on forex markets, and a monopoly on investment in the treasury bond (GKO) market. Moreover, the banks' influence prevented the passage of legislation to apply bankruptcy rules to them – in effect, the banks could not legally go bankrupt. Pressure by the bank lobby also ensured the adoption of the loans-for-shares program. With banking supervision capacity vastly inadequate to deal with the large number of banks, fraud, self-dealing, theft, and speculation could run essentially uncontrolled in the banking system. Moral hazard and failure of contractual discipline rippled through the system, setting it up for collapse. As the crisis approached in the summer of 1998, the banking lobby again intervened with government, preventing the seizure of two "oligarch banks" facing severe liquidity problems, and establishing a moratorium on their own foreign liabilities (eventually an actual bailout), which further undermined confidence and helped bring on the crisis.[45]

[44] Black et al (1999), p 4.
[45] *Id.*, Perotti (2000).

Figure 1: Early Transition in Hungary

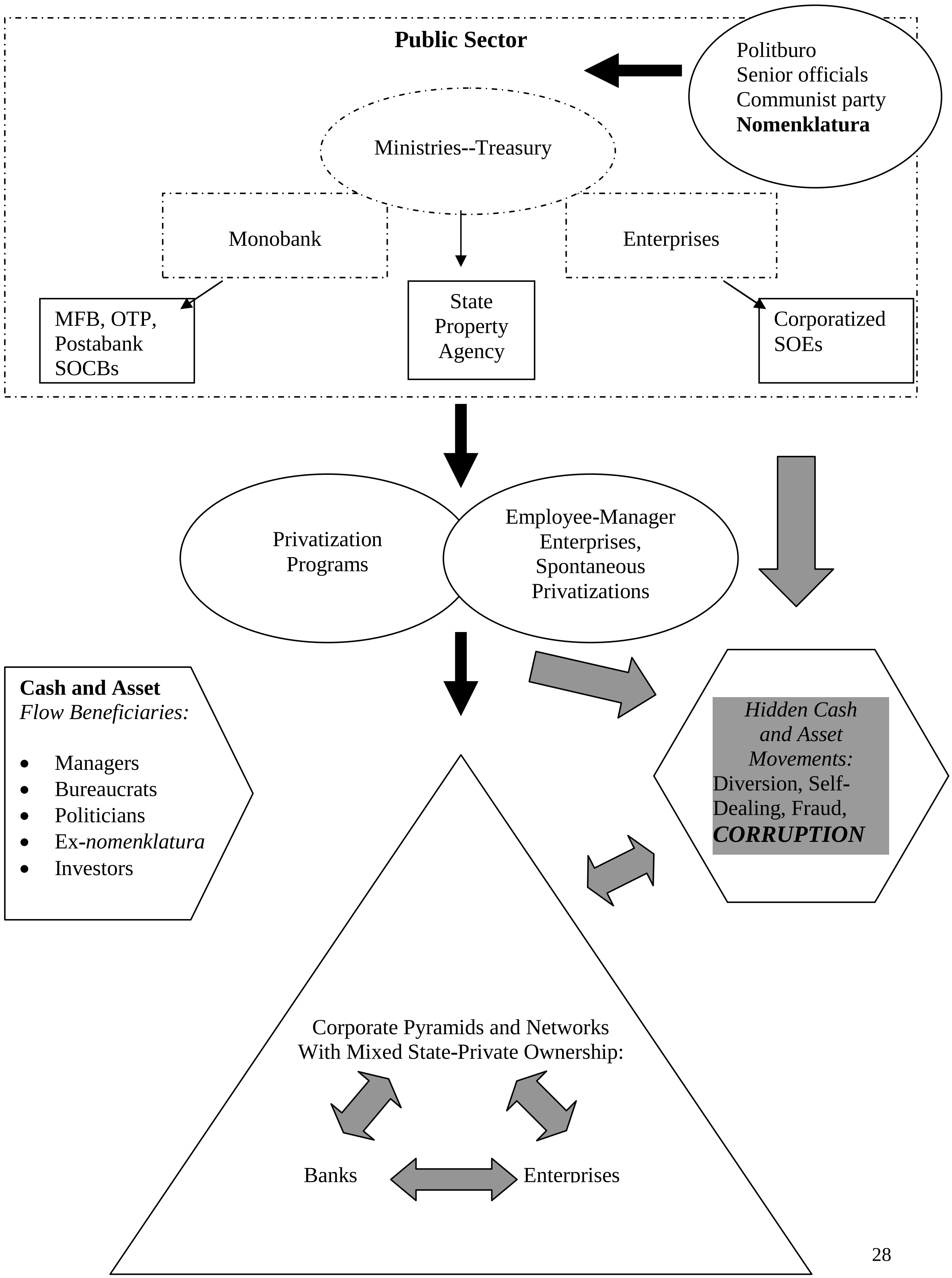
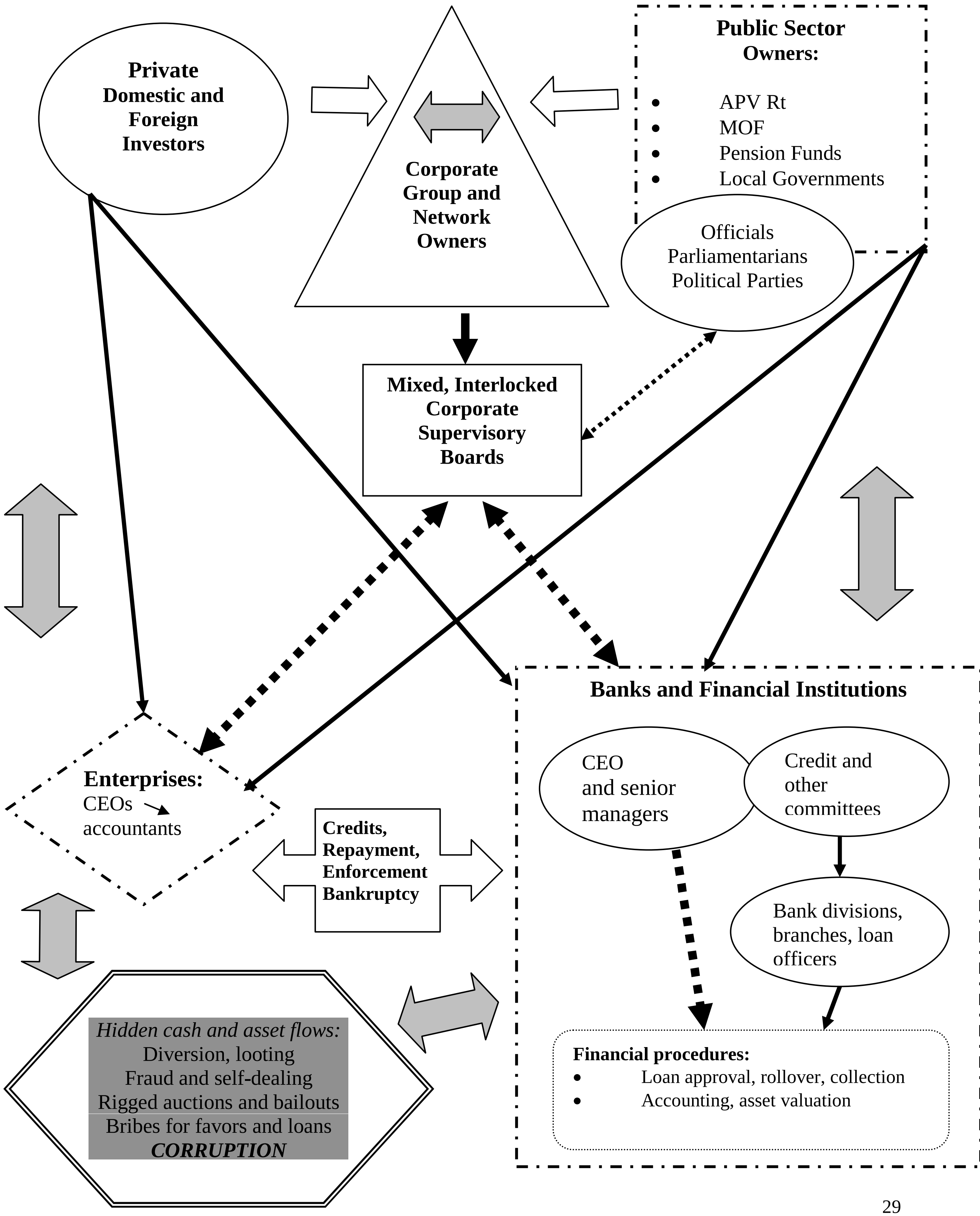


Figure 2: Mature Transition in Hungary



Chapter IV: Taking Action

In the early 1990s, Hungary stood as if on a precipice, the abyss of failed transition – with its eternal regress of instability and criminality – yawning before it. Would a coterie of oligarchs emerge, using state connections to mold the financial system for the benefit of hazy corporate networks? Which would gain the upper hand in the economy: producing value for investors or self-dealing? The rule of law or rule by cronies? Competition or corruption? The agenda for financial reform was daunting: hardening budget constraints, reorienting incentives toward the marketplace, taming a burgeoning debt overhang, imposing transparency, and securing businesslike ownership for state banks and enterprises. Simultaneous with this, the larger project of building the institutions of a liberal democracy and liberal economy had to proceed. Here, we present the main episodes in the financial reform drama, along with their proximate outcomes, some of which threatened to push Hungary over the edge. The longer-term impacts of these policy decisions are taken up in the next chapter.

Legislative Shock Therapy: 1991-2

Hungary's first post-communist government, led by Josef Antall, had to take decisive action or risk a downward spiral. The government faced up to the need for financial discipline in the economy as an antidote to the increasingly loss-making, mismanaged, and corrupt character of enterprises and banks. In 1990, the privatization law had come into force, and with it the State Property Agency. Orderly programs of enterprise privatization (in contrast to spontaneous or *ad hoc* privatizations) had gotten underway. What the government did next was somewhat more dramatic, sufficiently so that it has been dubbed "legislative shock therapy" (Abel and Bonin 1994). In late 1991, Hungary enacted new legislation on accounting standards, bank regulation, and bankruptcy in an attempt to change incentives across the economy in one bold stroke.

The new Accounting Law brought in internationally accepted accounting standards, thus providing the basis for improved financial transparency. The Banking Law[46] was designed to create discipline in the banking sector by imposing strict loan classification and provisioning requirements. The importance of accurate and transparent standards of accounting is self-evident, as is the desirability of strong prudential rules and banking supervision. These provide much of the foundation for confidence and fair business practice in the economy. The more difficult issue is the appropriate way to harden budget constraints – i.e., to keep the state, the banks, and the enterprises from subsidizing each other, hence undercutting incentives to restructure on their own. State initiatives towards restructuring and beginning to privatize SOEs provide part of the answer, along with bank restructuring and building a strong market environment. These were seen as necessary steps toward clarifying the status of the banks and preparing them for privatization.

[46] Act LXIX of 1991 on Financial Institutions and the Activities of Financial Institutions.

Box 4

Bankruptcy Reform in Transition Countries

A fundamental aspect of financial discipline is a business's responsibility for its debts, including its "exit" from the market when it can find no way to meet them. There are several elements here, the most central of which, for most analysts (and the Hungarian government in 1991), is a strong bankruptcy system. As one proverb has it, "Capitalism without bankruptcy…is like Christianity without hell."[47]

A well-functioning bankruptcy system is widely perceived to be an important part of regime change in transition. It affects the credibility of reform, helps change informal norms and incentives, and sends the signal both that the survival of loss-makers will not be guaranteed and that the rights of creditors will be respected. Strong bankruptcy rules and procedures are needed for a healthy long-term credit market, and may help improve the quality of bank assets necessary for strong banks and for bank privatization. Bankruptcy reform must inevitably balance drastic change, which helps to reverse bad incentives, with some form of accommodation enabling enough firms to cope so that the entire economy is not thrown into a tailspin. As Stiglitz puts it, "In countries with little entrepreneurship, poor social safety nets, and little tradition of labor mobility, we must expect a tilt towards debtor-oriented bankruptcy." (Stiglitz 1999, p 7) But, there should not be so much slack as to re-introduce soft budgets and moral hazard.

Here, at least two alternative sequences have been followed in transition countries. One approach, followed by the Czech republic, relies on rapid privatization to change incentives and attitudes in favor of market competition, but accommodates the inevitable disruptions by approaching bankruptcy reform slowly and cautiously. The opposite sequence involves cautious privatization as a way to accommodate disruptions, along with rapid bankruptcy reform to change expectations about budget constraints and competition.[48] Moreover, modern bankruptcy rules in most places internally balance discipline with accommodation by providing voluntary reorganization options in addition to liquidation.

While a balancing of interests must be embodied in the systems of bankruptcy and restructuring, the procedures adopted should be as swift and certain as possible. One aspect of this is the "trigger" for determining if a firm falls into the category requiring bankruptcy procedures. This could be based on simple cash flow or balance sheet insolvency. The first approach has the virtue of clarity and certainty (with the danger of being defined too strictly), while the second approach introduces much greater problems of accurate determination and discretion, thus leading to uncertainty as well as potential arbitrariness and corruption in the choice of firms. Another dimension concerns the matter of how the definition of bankruptcy is applied. The U.S. system and most others use a party-driven approach that relies on the market incentives of those involved to seek clarification and a fair distribution, or alternatively protection. Hungary for a time used an "automatic" trigger that required a filing when the defined conditions arose, on pain of legal penalties – but this created its own incentive problems.

A further aspect of swift and certain bankruptcy procedures is the role of the courts. The system should minimize court involvement in order to avoid uncertainty, delay, and manipulation. The limited judicial role in Hungary helps to keep bankruptcy reorganizations limited to 6-12 months, whereas they take two to three years in the Czech Republic. Delays open up the possibility of fraud and asset-stripping. This may be constrained to some extent by requiring debtors or liquidators to submit regular reports to the courts and providing liquidators the power to void transactions that are prohibited or fraudulent (although insiders are known to have undermined this by, among other things, destroying transaction records).[49]

But, in Hungary as elsewhere, without the ability to collect debts, banks become marginal in financial resource allocation as well as corporate governance, and tend to turn to the state for

[47] "Life after Debt," *The Economist*, June 10, 2000, p 87.
[48] Grosfeld (1998).
[49] Balcerowicz, E. et al (1998).

support when loans go bad.[50] The Bankruptcy Law[51] aimed to establish financial discipline in the enterprise sector. The major innovation in the law was the "automatic trigger"— this required managers to file for bankruptcy whenever the firm owed *any* debt that was at least 90 days past due for repayment (or face personal liability under the Civil Code). This approach was considered vital for reviving payment discipline in the Hungarian economy. It was also seen as a way to stop large state-owned firms from using their power to avoid paying debts due to smaller firms. The new law also made it very difficult for debtors and creditors to forge a debt restructuring agreement, by requiring unanimous consent of the creditors.[52] In the event, the new laws appear to have delivered some benefits, but with very significant short-term disruptions. The net outcomes of this legislation have been widely discussed and debated.

Predictably, the bankruptcy law led to a rush of filings after coming into effect in April 1992. Many were mandatory debtor filings under the law's trigger provision, but the majority came from unpaid supplier firms. In 1992 approximately 10,000 applications for bankruptcy were filed, and a further 7,000 in 1993. The mass of filings overwhelmed the legal system's already modest capacity. On the benefit side, the process was said, roughly, to have sorted viable from non-viable firms, and reorganizations were concluded relatively quickly (but not liquidations, which were slow). This proved a major stimulant to the privatization of SOEs. It also had the advantage of revealing the weak state of the enterprises' accounts and the banks' portfolios.[53]

On the down side, it is widely recognized that the law's design was too harsh, and indeed the automatic trigger provision was rescinded in a 1993 legislative amendment (as was the requirement of unanimous creditor consent to restructuring plans). It has also been argued that the law (or at least the automatic trigger) was unnecessary, based on firm and bank data suggesting that creditors (except for the tax authorities) were already tightening budget constraints, essentially cutting off delinquent debtors from new credit. Moreover, many otherwise healthy firms filed for bankruptcy due to temporary liquidity problems - and so were essentially cut off from credit, since new credits extended after the process began were not legally protected. Thus, legislative shock therapy appears to have caused unnecessary disruption and intensified the economic downturn. The ripple effect may have added to the buildup of existing debt becoming non-performing (reported as 262 billion HUF at the end of 1992), but the incentives at play (e.g. avoiding mandatory bankruptcy and the expectation of later bailouts) delayed accurate loan classification, as well as discounting and workout of debt.[54]

There is also evidence that the new bankruptcy rules created corrupt incentives, encouraging informal arrangements to evade the law as well as self-dealing and illicit enrichment. It is widely believed that SOE managers essentially controlled the bankruptcy proceedings. This enabled them to use bankruptcy procedures as mechanisms to acquire their firms (i.e., taking the firm into bankruptcy and purchasing it at an asset sale) without resort to official privatization through the State Property Agency, or to eliminate their payment problems by creating joint ventures with their creditors. Frequently, SOEs owned shares in their creditor banks (in some cases having been purchased with loans from the same banks) and used their leverage to ensure a steady flow of credit. Thus, state assets (e.g., fixed assets, labor, intangibles) were diverted to subsidiaries or private firms, leaving the state with only shell corporations to enter reorganization or liquidation. Many bankruptcies were apparently initiated by managers who had already

[50] Gray et al (1998).
[51] Act IL of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Voluntary Dissolution.
[52] Mizsei 1994.
[53] World Bank (1998), Gray et al (1998), Bonin and Schaffer (1999).
[54] Mizsei 1994, Bonin and Schaffer 1995 and 1999.

diverted valuable assets and were waiting for liquidation (a frequent result of slow privatization, e.g., in Bulgaria and Ukraine). Liquidation delays arose from the slowness of the courts in appointing liquidators. The incentives for liquidators under the bankruptcy rules encouraged them to delay: they could (and still can) receive two percent of the gross receipts of a firm as long as it stayed open. Hence, many liquidations were prolonged and the firms kept open in the meantime. Some creditors apparently colluded with debtor firms in order to secure prompt repayment unfairly (and illegally) at the expense of others.[55]

Clearly, the design of the bankruptcy law and its procedures contributed a great deal to these problems, but there were other causes as well. Democratic political and legal institutions were in their infancy at the time. Thus, judicial processes that might have helped ensure rapid and transparent bankruptcy procedures were too inefficient, expensive, and cumbersome for the job. Bankruptcy was slower, and more expensive and risky, than pure asset-stripping. The infrastructure of information and watchdog agencies (e.g., accountants, credit reporting agencies, lawyers, and the press) was too weak to prevent these abuses. At least as important, both debtors and creditors (especially the majority that were still state-owned) entered this bankruptcy experiment with the belief that they could still avoid collecting or paying debts by relying on each other and on the state to tide them over (especially since enterprise and bank recapitalizations were under discussion in 1992). Many did all they could to ensure that this took place despite the letter of the law.[56] In short, the bankruptcy reform attempted to interpose a market-oriented legal framework in the face of a larger (*de facto*) regime of ownership and governance that provided stronger market-contrary incentives. It did not succeed.

The banking law led to changes in bank practices and the restructuring of loan portfolios based on the need to provision for bad loans. Importantly, this is believed to have forced bank managers to recognize, and to report, their losses and weak balance sheets – i.e., these new rules (along with the new accounting standards) helped make the financial system transparent, at least over the longer term. This included limits on connected lending, although there was no sanction for violations at the time. The critical problem was that the classification and provisioning standards at the time of their introduction were too severe for the banks honestly to assess the quality and condition of their loans. This also encouraged informal arrangements to mitigate the law's effect. If the banks reported the performance of their loans accurately, not only would this result in mandatory provisioning, hence an immediate reduction in loanable funds, but it would also force all of their delinquent clients into bankruptcy. The banks faced still more potent adverse incentives beyond this, since the reassessment of their loan portfolios occurred at the same time that the government was negotiating a bailout of the financial sector and selected enterprises. This encouraged the banks at least to complement their efforts to improve portfolio quality with political lobbying to gain the largest amount of money from the government. In addition, the government failed to coordinate financial policy implementation and to build the necessary capacity for effective banking supervision during the 1991-3 period, with the result that banking in the near term became riskier, more politicized, and more corrupt.[57]

The advocates of shock therapy across the transition world miscalculated the efficacy of rapid privatization by itself to solve the problem of switching to market-based profit incentives. Similarly, the advocates of Hungary's legislative shock therapy overestimated the effectiveness of legal enactments to re-direct behavior along new lines. The legislation was well-regarded at the time, as it was developed with extensive Western input and embodied prevalent thinking about

---

[55] Stark 1996, Gray et al (1998).
[56] Gray et al (1998).
[57] Mizsei (1994), interviews and researcher observations.

how to impose hard budget constraints, transform incentives, and create financial discipline in transition environments. However, the legislation produced unanticipated effects that undercut the measures' objectives, at least in the near term. It proved impossible to legislate effective governance in the face of contrary patterns and incentives arising from incomplete restructuring, adverse ownership arrangements, and a legacy of corruption driven by shadowy business networks.

Moving the Debt Mountain: 1992-4

Everywhere, economic transition saw a massive buildup of non-performing debt, as SOEs came under pressure to restructure. The vast majority of firms (for example, IKARUS, Hungary's manufacturer of large vehicles such as passenger buses) produced entirely for the domestic and Soviet bloc markets, which evaporated almost in an instant with the dissolution of the Soviet Union. In Hungary, this event came at virtually the same time as the launch of legislative shock therapy, and the combination served to deepen the crisis. As a result, the stock of bad debt built up quickly, with most debtors lacking any realistic prospect of repayment.

What to do? The designers of the 1991 legislative reforms in Hungary surely anticipated a rash of bankruptcies and closures – transforming incentives is a wrenching process after all. However, the resulting disruption threatened to bring the economy to a standstill. As in other transition countries, policymakers faced the question of how the government might intervene to help sort out the debt overhang and thus to mitigate the effects of the crisis sufficiently for restructured firms and banks to emerge. Inevitably, the policy discussion turned to the formulation and negotiation of recapitalization programs.

In the event, Hungary carried out three major programs involving elements of debt consolidation and restructuring, bank recapitalization, and enterprise rescue:

(1) A portfolio cleanup whereby the government carved out the banks' bad loans, swapped this debt for treasury bonds, and transferred the bad debt to a "hospital" bank (1992-3).

(2) The bailout of selected large state-owned enterprises employing in excess of 7% of the industrial labor force—initially the "dirty dozen," then the "sour sixteen" (1992-3).

(3) A final integrated program involving the injection of additional capital into banks, then requiring them to deal with their bad loans and to correct their underprovisioning of non-performing loan portfolios (1993-4).[58]

[58] Balassa (1996), Anderson and Kegels (1998).

Box 5
Debt Restructuring Issues

What choices were available to Hungary in dealing with its debt problem? One approach (tried, for example, in Bulgaria and Romania) was simply to cancel debts among the state-owned banks and firms. This debt, in any case, concerned entities wholly (or largely) owned by the state, and was originally (in some cases still) recorded on either side of the state treasury's balance sheet. However, debt cancellations have usually ended up sending the wrong signal, thus encouraging unprofitable SOEs simply to continue borrowing.[59] Alternatives include voluntary contractual debt workouts between the parties, and a state program of case-by-case recapitalizations. Contractual workout has the virtue of being consensual and based on information known to individual debtors and creditors, but the agreements bind only the parties bilaterally. By contrast, bankruptcy reorganizations and state recapitalizations bind all affected debtors, and all relevant creditors. Case-by-case restructuring (used by Poland as well, in fact, as Hungary), if appropriately designed, works better. This approach has pitfalls. It requires adequate capital and should be targeted to restore the health of the financial system in anticipation of large-scale enterprise and bank privatization. Moreover, one version of this, debt-equity conversion (used in Poland, and in Russia under the name "loans for shares"), has been known both to create corrupt incentives and to result in continued state ownership due to SOCB acquisition of shares – hence no (or negative) net privatization.[60]

There are a number of critically important banking governance issues to be considered here. Most obvious perhaps is the need, at least eventually, for strong prudential rules and systems for supervising sound bank practice, as well as a broader framework for the rule of law. Bank recapitalization presents some of the gravest risks. To be effective, it must reward prudent management – although many programs have covered new flows of bad debt, thus increasing the benefits for badly-run banks. In recapitalizing banks, policymakers therefore need to bear in mind the difference between new and old debt. On the other hand, the too-big-to-fail phenomenon could undercut attempts to maintain this distinction in the larger institutions. Concerning the workout of bad debt, the strategy should balance the need for involvement by the banks themselves, as repositories of information on firms, against the possibility of self-dealing (e.g., banks buying back their own portfolios at a steep discount, perhaps through related companies). A related issue is the extent to which current management should be allowed to continue to run recapitalized banks. On the one hand, removal of ineffective managers may send a signal that promotes discipline and accountability, while bringing in outside managers who are likely to be less cozy with non-paying debtors. On the other hand, this may worsen incumbent management's *ex ante* incentives, encouraging the rolling over and underreporting of bad loans. By contrast, a policy of allowing management to remain in place not only signals a lack of accountability, but may motivate managers to take an overly tough approach to firm liquidations and thereby to exaggerate the creditor banks' recapitalization requirements.[61]

In the end, it is critically important for restructuring and recapitalization programs to help move the system away from subordination to state policies and strong influence by client firms – both of which compromise financial governance. One goal should be to place banks in a more independent posture. The Czech and Polish approaches not only failed to achieve this, but in fact made these links even tighter. The Czech reforms left the state with large stakes in the major banks, and through voucher privatization provided the banks with additional ownership stakes in their client enterprises. Removing bad loans to a hospital bank did not thereby remove the "bad" clients or their soft budget constraints. Poland implemented a bank-led restructuring program, based on the idea that banks would be in the best position to use firm-specific information to work out bad debt. In fact, the Polish banks extended more credit to ailing SOEs than they received in recapitalization funds, thus deferring the day of reckoning for many firms and deepening the banks' own links to undesirable clients. This suggests that a better strategy would be to link bank recapitalization to the strengthening of market incentives, making it explicit that state support would be cut off and that the banks would be as fully privatized as possible to independent investors.[62]

---

[59] Balcerowicz, E. et al (1998).
[60] If feasible, a better option would be to arrange for the sale of discounted debt on secondary markets. *Id.*
[61] Maskin and Xu (1999).
[62] Abel and Bonin (1994), Bonin and Huang (2000).

One observer suggests that the Antall government in late 1992 “allowed itself to be blackmailed by the top managers of the large banks” into cleaning up their balance sheets in order to hasten urgently-needed privatization. (Stark 1996) As it turned out, the initial program in 1992-3 did not bring privatization closer, but is viewed as having intensified the banks’ incentive problems. This bailout was hastily prepared, and not carefully targeted. It did not undertake the fundamental restructuring needed to ready the large banks for privatization, nor did it provide enough capital to make a significant difference. Moreover, the initial program moved bad debts into a “hospital” factoring agency (the Hungarian Investment and Development Corporation) with little capacity to rework debts – thus substituting a less capable and experienced agency for the banks in decision-making, and undercutting the banks’ responsibility. The initial program also led to “strategic” recognition of bad debts by the banks in response to the proffered debt carveout and tax incentives. One year after its launch, the banks’ balance sheets looked worse than they did when the program started (and much worse if one factors in the amount of debt cleaned up under the program). This should not have been surprising, since bank managers had not changed and apparently many of them, rather than placing the treasury bonds in reserves, used them to continue making loans to loss-making enterprises. The second program, an enterprise rescue program, although it did not directly involve the banks, apparently was politicized and occasioned some collusion by banks and firms to maximize benefits to the latter. Eight of the participating firms simply had their debts forgiven in early 1994 after failing to present reorganization plans.[63]

The final program combined bank recapitalization with loan consolidation and enterprise rescue. While providing relief to major enterprises from large debt overhangs, the program aimed to resolve the banks’ liquidity problems by supporting a conciliation process for loan workout, by injecting sufficient capital to cover loans classified as “bad” and “doubtful,” and to bring the capital adequacy ratios of participating banks up to four percent by May 1994, then up to the Basel capital adequacy standard of 8% by year’s end. In return, the government required the banks to keep current in their provisioning against qualified assets, to modernize their operations, and to bring all their accounting procedures into line with international standards. In all, eight banks and 55 firms became eligible to participate in the program. The debt conciliation program brought all private and public sector creditors together to negotiate a restructuring plan proposed by the debtor, involving resolution of the debt through a combination of debt rescheduling, forgiveness, debt/equity swaps, and forgiveness of tax arrears and penalties in the case of the customs and tax departments. This part of the program concluded in mid-1995. The MOF supervised these processes, obtaining a “golden share” in the participating banks.[64]

Three major incentive problems arose from this program design: (i) the inevitable jockeying (and corruption) by enterprises to get on the eligibility list, as in the prior program, and their incentive to remain on public support; (ii) the tax forgiveness dimension of the program, which undercut discipline in the crucial area of tax arrears; and (iii) the “level playing field” approach to bank recapitalization, which brought all participating banks up to the same capital adequacy ratio, thus rewarding badly-run banks more than the well-managed ones. (Bonin and Schaffer 1995) The selection of the 55 firms was made a few months before the 1994 elections, apparently at least in part on political grounds, out of some 2,000 applications. According to some of the bankers involved, these enterprises’ restructuring plans were hurriedly assembled and of poor quality. Moreover, having obtained secure provisions against their bad loans, the banks

[63] Mizsei (1994), Bonin and Schaffer (1995), Balassa (1996).

[64] This is usually defined as a minority share with special veto rights. It was in this case unnecessary, since the recapitalizations resulting in consolidated state shareholdings of between 68 and 95 percent in seven of the eight banks. Bonin and Schaffer (1995), Balassa (1996)

did not aggressively pursue liquidation and many firms did not apply for debt forgiveness, in part allegedly because many of the loans were fraudulent and the borrowers had long since gone out of business. Meanwhile, as banks' capital position improved, the stock of bad debt continued to grow. Some attempts were also apparently made to sell bad loans, which had already been provisioned at 100% (usually at the state's expense), to the State Property Agency – in the flurry of giveaways, favors, and diversions of funds marking the runup to the 1994 elections.[65]

In essence, a first failed program led to the need for a second program that also failed, thus creating the need for a third program. The first program managed to recover only about five percent of the bad debts transferred to the specialized hospital bank. In the second program, firms had a strong incentive to be included among the chosen beneficiaries, and some worked to enlarge their debt packet and lobby for inclusion. When these approaches failed, the government tried a new design in the last program, keeping in place the bank managers who knew the clients and environment, while making it clear that no further bailouts could be expected. This structure, along with increasing momentum in real sector privatization and restructuring, finally proved effective in disposing of the most serious non-performing debt problems.[66] When the government made it clear that it would recapitalize and then sell off the banks, the nature of the incentive, management, and portfolio problems came more fully into the open. These initiatives also left behind a workable structure for dealing with bank failure. The NBH now has the authority and the means to consolidate a loss-making bank and to supply emergency loans to financial institutions under defined conditions. Where a bank becomes insolvent, bankruptcy proceedings may be initiated by the bank in question, by a creditor financial institution, or by the bank supervision (now known as the Hungarian Financial Supervision Department).

Hungary's experience with consolidation and recapitalization was costly. The direct costs of these programs have been estimated at HUF 330 billion, amounting to 9.4 percent of (1993-4 average) GDP and 18.3 percent of the national budget for 1994, and including the sale or write-off of more than 11 percent of the banking system's total assets. It took three to four years to work out the worst of the debt problems, a delay that imposed further costs due to continued losses, asset-diversion, and corruption. One conservative "guesstimate" is that some ten percent of the banking system's overall portfolio was affected by corruption of some kind. Research showing that Hungarian banks did not extend new credit to non-paying debtors to any large degree (hence were tightening firms' budget constraints) seems to suggest that the program did not in fact create a major problem of moral hazard. However, there appears to be a consensus that the recapitalizations – at least the initial ones – did not help matters and indeed helped intensify problems of incentives, transparency, and state intervention in the financial sector.[67]

New Faces, New Approaches: 1994-5

During the debt restructuring efforts just described, in mid-1994, the government changed hands. The first post-communist government, the center-right coalition led by the Hungarian Democratic forum and Prime Minister Antall, had had a generally antagonistic relationship to entrenched economic interests, especially firm managers. The government spent significant resources trying to wrest control from them, but the net result was stalemate – managers could not fully privatize their firms and neither could the state. The dire financial

[65] Stark (1996), Anderson and Kegels (1998).
[66] Interviews, researcher observations.
[67] Bonin and Schaffer (1995) and (1999), Stark (1996), Karvalits (2000), Economist Intelligence Unit (2000), Interviews.

condition of the country also forced the government to rely heavily on the banking sector since it needed bond finance. The next government, led by the Hungarian Socialist Party under Gyula Horn, came to power in the elections of May 1994. This government had a close relationship with the economic power centers, dating from their shared experience in the state structure beginning in the early 1980s. The Horn group, despite its position on the left, had not only more experience in public administration but also a better practical grasp of economics than the previous government. Its economic program succeeded in achieving a significant restructuring of the economy, spurring growth, and encouraging dynamic new firms.[68]The governance benefits of this will become clear in the discussion that follows.

One of the key steps that eventually made economic reform successful was the Horn government's adoption, in March 1995, of a tough stabilization program known as the "Bokros package" (after then-Minister of Finance Lajos Bokros). The program called for social spending cuts to help address the massive fiscal deficit (which had been significantly enlarged by the bailouts), a currency reform involving the devaluation of the forint and introduction of a "crawling peg" regime, and a strict incomes policy. It also included structural changes linked to macroeconomic reforms, i.e., a medium-term reduction in the overall size of the public sector, and a more ambitious set of targets for the of privatization of SOEs and SOCBs. In March 1996, the stabilization program was reinforced through the government's signing an official agreement with the IMF. As a result of the Bokros package, the overall state budget deficit went down from 8.2% of GDP in 1994 to 3.2% in 1996.[69] Importantly, this adjustment package was not forced on the country through emergency measures or authoritarian control – indeed, the cuts in public spending on family allowances and education were struck down by the courts.[70]

The Bokros package helped to break Hungary's transition stalemate and usher in a period of significant restructuring. The currency reform provided immediate benefits to export-oriented manufacturers. Having stabilized the economy and pacified the managerial lobby, the government was then able to pursue privatization more vigorously, particularly in the banking sector. The government indeed established a bank privatization program that sold off almost all of the banks, while limiting the impact of bad loans, thus turning the Hungarian banking system into one of the strongest in the region. Oddly, a socialist government with strong links to the old enterprise managers is credited with having brought about a significant depoliticization of the economy.[71] How did this happen? To this story we now turn.

The Banks Change Hands: 1995-7

In transition environments, restructuring banks without privatization does not appear to work, since state ownership – and the influence on bank governance that this facilitates— remains. Privatization (if carried out effectively) can reduce the benefits to politicians of directing credit, force industrial subsidies into the fiscal system and therefore out into the open, and help generate new constituencies for an efficient financial sector. This insight seems to have been widely accepted and made part of the policy of leading transition countries in the early to mid-1990s. However, it proved difficult to put into practice because the transformation of ownership incentives requires more than selling off partial stakes.

[68] Researcher observations.
[69] It increased slightly to 4.6% in 1997. EIU 2000
[70] World Bank (1998).
[71] Researcher observations.

In Poland and the Czech Republic, bank privatization accompanied enterprise privatization, along with attempts to harden budget constraints (in these cases, breaking the pattern of state credits to SOEs). In Poland, SOCBs began to be individually privatized starting in mid-1993, with the state retaining approximately a 30 percent share in each. After these sales, the state still owned about two-thirds of total banking system assets. The Czech Republic included nearly all state-owned banks in its first wave of voucher privatization in 1993. There, the state kept a 40-45 percent share of each bank. In both cases, earlier attention was given to resolving the non-performing debt problem.These processes were not without their problems of murky governance and illicit dealing. In Poland, as in Russia, some enterprises set up their own banks as sources of loans. In Russia, many banks set up investment funds that they controlled, to participate in mass privatization, including the privatization of the originating banks.[72]

Also, while state ownership may facilitate government influence over the banking system, it is not necessarily the only channel for this. Under communism, not only was banking fully part of the state bureaucracy, but monetary control and credit allocation functions were not differentiated. Although Hungary and other East European countries had by 1992 moved away from direct credit limits and interest rate controls, toward indirect monetary policy tools favored in industrialized countries, nevertheless credit continued to be directed by the state (although to a lesser extent than before). Long-term subsidized refinance credits to particular sectors continued to play a significant role at least through the mid-1990s (in Hungary representing over ten percent of long-term credits outstanding to the private sector). This approach obscures both the governmental influence on credit allocation and the cost to the public of subsidizing industries, usually declining sectors with significant employment (hence political influence). Even more dramatic as a form of state influence on credit markets is the amount of government borrowing, and resulting crowding-out of lending to the private sector, amounting to over 70 percent of the credit stock in Hungary from 1993 to 1995 (down to 61.5% in 1998, see Table 2). In other words, until at least the mid-1990s and in some respects more recently, government withdrawal from credit allocation was far from complete in Hungary and comparable countries such as Poland and the Czech Republic.[73]

[72] Mortimer (1995), Anderson and Kegels (1998).
[73] Anderson and Kegels (1998).

Box 6

Foreign Investment in the Banking Sector

An often sensitive issue that arises with the move toward bank privatization is to whom the banks should be sold, and what role foreign investment should play in the process. The analysis of corporate governance suggests the importance of strategic investors, i.e., not portfolio or absentee investors, but those who take a substantial (in effect, controlling) share, and for whom the investment is a strategic expansion of their core business – in this case, banking. In an early transition environment especially, the best source of strategic banking investment is likely to be foreign, i.e., from the developed industrial countries. Especially where economic transition has resulted in mixed incentives for local banks – with self-dealing and rent-seeking strategies competing strongly with profit-maximizing strategies – the entry of strategic foreign investors from leading economies can be expected to bring corporate governance benefits to the banks and enterprises in which they invest. Such investors are more likely than local entities to take an actual controlling share and to use this power to restructure, to monitor the management, and to ensure the protection of their interests and investment expectations.

The fact that foreign investors are enmeshed in an international business environment and usually do not have strong local ties has potentially important implications locally. Foreign entrants will tend to disband inherited local networks involving the firms they acquire. They usually prefer to operate on the basis of transparent legal arrangements, internationally-accepted accounting principles, and competition on a "level playing field" of law and regulation. This can be expected to bring increased pressure for good governance. Furthermore, foreign banks tend to be less politically connected, hence less likely to "capture" regulators in host countries or to do favors for local politicians – thus making the necessary regulatory reforms more likely. Foreign investment potentially brings still further economic benefits: product and service innovation, economies of scale and scope, competition, spurring the development of financial markets (especially the inter-bank market), the spillover effects of good banking practice, and the prospect of pulling in other kinds of foreign direct investment.[74]

However, there are also several arguments against foreign investment in banking. The arguments are based on the fear of foreign control of the financial sector, the supposed need for infant industry protection, the "special" or "strategic" nature of banks in the domestic environment, the conflicting objectives of foreign banks and local banking, as well as regulatory differences between the home and host countries. There is also the concern that foreign banks will "cherry pick" the best banking clients, leaving local banks with the weakest clientele and hence the most difficult prospects of profitability. As a result, it is common for even the wealthiest countries to restrict foreign banking severely, and even to protect local interests through heavy state involvement. These arguments have carried some weight in transition countries, and while some opened up very slowly and cautiously, others have been very liberal at times

Getting foreign banks interested in acquiring state-owned banks in transition countries is often a major challenge in itself. International banks have concerns about SOCB balance sheets, management quality, corporate relationships, and the possibility of continued government intervention. The long-delayed acquisitions of Komercni Banka in the Czech Republic, United Bulgarian Bank in Bulgaria, and Budapest Bank in Hungary illustrate this problem. Depending on the quality of local banks and the restrictions placed on them, foreign investors may decide to focus only on "greenfield" banking investments (as in the Czech Republic until the mid-1990s) or to stay away altogether.[75]

Moreover, the SOCBs carved out of the state monobank have frequently proven too big and too politicized to change, hence privatization alone does not insure bank governance that is transparent and independent of political influence – and it can easily entrench insider control. This suggests the urgency of restructuring, strengthening corporate governance, and putting an effective regulatory structure in place in tandem with privatization. The style of privatization also has important effects on post-privatization governance. Poland experimented successfully with

---

[74] Kroszner (1998), Mortimer (1995).
[75] Mizsei (1997), Bonin et al (1998), Dilova-Kirkowa (1999).

privatization to a strategic foreign investor (e.g., in the Bank Slaski case), but its main approach has been IPOs resulting in sales of shares to dispersed owners. The latter approach was still more pronounced in the Czech Republic, where voucher privatization of the banks led to dispersed ownership by voucher funds and private investors, with core shareholdings remaining with the state (augmented in many cases by cross-ownership). In both cases, state and insider control predominated after these privatizations, in some cases intensified by especially influential bank CEOs, governmental attempts to orchestrate bank consolidations after privatization, and some resistance (especially in Poland) to foreign ownership.[76]

One of the chief lessons in this area has been neatly summarized as follows:

> Any government that is not committed to the advantages of having new owners, foreign or private domestic strategic investors, for the SOCBs may use this excuse to consolidate the domestic banking sector into a cartel beholden to its political parent.[77]

More broadly, where these issues of bank restructuring, privatization, and foreign investment have their practical outcomes is in determining how banks behave at the end of these processes: do they act like private banks?

Hungary Chooses Bank Privatization:[78]

Early in Hungary's transition, key officials resisted bank privatization, since the banks were connected to other state enterprises, and if privatized would presumably stop financing them. But, it gained momentum toward the mid-1990s, when the scope and cost of bank insolvency became clear, along with the extent of problems in the banks, including moral hazard, malfeasance, and corruption. The key players in bank privatization were two highly-regarded reformers: Gyorgy Suranyi, head of the central bank (National Bank of Hungary or NBH) and Minister of Finance Lajos Bokros. The two concluded that large-scale theft and loss in the banks had to be stopped, and the banks transformed into market competitors. They were able to convince Prime Minister Horn that bank privatization (i.e., sale of controlling shares) was unavoidable if the government wanted to keep the financial sector from becoming a "bottomless pit" of bailouts. (This was a reversal for both of them, since they had opposed bank privatization in 1990-1). The Hungarian government had already, in 1992, articulated a goal of reducing the state's ownership in each of the SOCBs to less than 25 percent by the end of the 1990s. In addition, there had been some small bank privatizations, as well as some greenfield foreign bank operations established. Moreover, in 1994 signficant shareholdings in the Hungarian Foreign Trade Bank (MKB), the third-largest bank in the country, had been sold to a group of foreign investors including a German bank and the EBRD. (Bonin et al 1998, Mihalyi 2000)

Moreover, the government decided that privatization had to include substantial foreign investment. Here, too there had been early resistance. In 1990 there had been serious bids by foreign investors for two of the SOCBs. When the investors asked for a commitment that they could increase their stake from the initial 49 percent to 51 percent, this was deemed to be politically impossible, and enthusiasm for foreign participation in the banks eventually waned as major problems appeared in the sector. By 1994-5, the logic of inviting foreign investment became much more compelling, apparently for two main reasons: the state's large balance of

[76] Bonin et al 1998.
[77] Bonin et al (1998), p 54.
[78] The events depicted here are more recent and less thoroughly documented than earlier events, hence the discussion in this section and the one following relies more heavily on findings from interviews.

payments deficits, and continuing governance failure in the banking system. In the late 1980s it was already becoming clear that Hungary needed major foreign direct investment (FDI), since the state was massively in debt. By 1991, the central government deficit had reached 5.5 percent of GDP, and it grew to 7 percent by 1995. (EIU 2000) The government's hands were tied by fiscal constraints – a classic spur to reform throughout modern history. It also may have occurred to Bokros, Suranyi, and others that – as it indeed turned out—strategic foreign investors could not only upgrade the banks' capital and modernize their practices, but play a major role in insuring effective corporate governance as well.

However, getting foreign investors interested in Hungary's banks would not be easy by the mid-1990s. They would only come in if corporate governance was transparent and effective, if macroeconomic conditions were sound, and if the banks had credible portfolios and balance-sheets. At that time, the legislative reforms, recapitalizations, restructuring efforts, and real sector privatizations were showing signs of turning the economy – and with it the financial sector – around. Macroeconomic adjustment was also fundamental – the bank privatizations might not have happened without the Bokros package in place by 1995.

The policy of bringing FDI into the banking sector evoked the usual objections, but the Horn government stuck to the Bokros/Suranyi policy. A few specific features of the environment in Hungary helped defuse opposition. Unlike Russia, Hungary did not have major employee ownership of enterprises, which supported Russia's more protectionist approach. Moreover, Hungary's main corporate insiders did not have extra local sources of capital (such as natural resource rents), and so could not revitalize without FDI. It helped a great deal that Hungary had already had foreign investors and private owners (since the 1980s, and previously in the inter-war period), who helped pressure the government for a liberal framework. It had experimented with a mixed economy since 1968, liquidating about one-third of its SOEs early on. Even those involved in profiteering through spontaneous privatizations wanted to gain access to foreign capital, and so tended to become converts to laws and policies that would facilitate it. It was also clear to many that the state was fundamentally a bad owner and should be replaced. The government did little more than place representatives on the banks' corporate boards. The result tended to be untrained, weak bureaucrats sitting on the boards in order to earn an extra allowance – for example, 90 percent state ownership in a bank might have been represented by someone who in practice exercised no real power, but only took notes. In the end, the government's fiscal bind probably did most to tip the balance, along with pressure in this direction from international institutions including the EU and the World Bank.

A new Privatization Law was approved in May 1995,[79] which consolidated the separate state property and asset management agencies into a single State Privatization and Holding Company (APV Rt). The government at about this time also adopted a policy of permitting 100 percent foreign ownership of Hungarian enterprises and banks. The speed of privatization in general increased greatly at this time with the value of privatized state assets tripling from 156.7 billion HUF in 1994 to 480 billion HUF in 1995. State ownership in the banking sector shrank from 67.3 percent in 1994 to 32.8 percent in 1996, with a simultaneous increase in foreign ownership from 14.9 percent to 48.1 percent, and a further rise to just over 60 percent by 1998. (EIU 2000, World Bank 1998) Bank privatization should have been the same as enterprise privatization in principle, but bankers were more successful in securing treatment as a special or strategic sector. As a result, bank privatizations largely took place outside the regular privatization processes applied to some 2,000 large SOEs. The bank privatizations were handled

[79] Act XXXIX of 1995 on the Sale of State-Owned Entrepreneurial Assets.

not by APV Rt, which focused on real sector enterprises, but by the Ministry of Finance – an arrangement that proved to be a mixed blessing.

Minister Bokros effectively took control of bank privatization. A conflict ensued between him and the head of APV Rt, which was charged with leading all privatizations under the 1995 law.[80] This dispute has been described as both a policy difference and a straightforward struggle over power and patronage. APV Rt preferred privatization within a straightforward legal framework in which the best cash offer always won the tender, as provided for by its statute, and in order to avoid discretion and questionable deals. The Ministry of Finance (MOF) wanted additional criteria for awarding privatization tenders, such as the size of capital increase planned, the acquirer's market strategy, and especially the presence of a strategic foreign investor (APV Rt considered these factors, but only marginally). There is also reason to believe that CEOs of privatizing entities helped push government control from one agency to another, depending on where their strongest personal relationships existed. The 1995 Privatization Act made APV Rt the formal manager of most SOE and SOCB privatization, empowering it to corporatize state entities, to exercise the government's rights as a shareholder, and to structure privatizations. However, the Act has been amended by Parliament (11 times to date), usually to switch government ownership, including the substitution of the Ministry of Finance for APV Rt in bank privatizations.[81] The agency in charge of specified privatizations under the Act thereby obtains access to additional resources, the right to appoint representatives of its agency to sit on corporate boards (for which they earn a fee), and authority over privatization transactions, including the management and use of sale proceeds. The business and banking community viewed the MOF as the "lesser of two evils," and APV Rt as the more politicized (and corrupt) agency.

The Process and Major Deals:

Six major banks were privatized under the procedures set up by the MOF in 1995. Closed privatization tenders were directed to well-known and reputable foreign banks (to keep disreputable actors out), and bidders were usually selected each from a different country (to allay sensitivities about favoritism or collusion). Three independent audits of each local bank on offer had to be carried out before privatization began.[82] In 1996, not long after the bank privatizations began, the U.S. Treasury Department and the EU PHARE program began supporting the program with expert advisors and other forms of assistance. These programs and the bank privatization effort in general, were helped by the pressure exerted by the World Bank (under a $225 million adjustment loan) on the Hungarian government to make progress on privatization and to cover its fiscal deficits.[83]

The process effectively moved most of the banking sector out of government hands and brought in substantial foreign investment – but the deals were murky, including instances of distortion and corruption. One of these was the case of a small privatization involving a bank subsidiary: two minutes before the bid submission deadline, a crony of a powerful government figure arrived with a bid exactly $1.50 higher than the previously high bid. In several such cases, the bank privatization group was able to catch and correct the problems in time, but in other cases, questionable activities only came to light later. While disagreement exists about the extent

[80] Bokros left the government in 1996, apparently forced to resign, but the MOF-APV Rt dispute lived on.
[81] The previous Act, from 1992, had allowed this change by decree.
[82] The sale process usually included these standard steps: announcement of the tender, initial due diligence, information memorandum, marketing by investment bankers, issuance of the tender, provision of price information by the bidders, shortlisting, full due diligence, bidding, ranking of bids, and negotiations.
[83] *Transition*, April 1997.

of irregularities in Hungary's bank privatizations, the outcomes generally appear to have been consistent with the desire for a competitive and well-governed banking market. Only one local bank is known to have been acquired by an industrial group: AEB, a small insolvent bank, was bought by an affiliate of Gazprom.[84]

Following, are highlights from a few of the major bank privatizations.

OTP, 1995: This was the national savings bank and the largest bank in Hungary, accounting for 31 percent of total banking sector assets. OTP had been founded in 1949, corporatized in 1991, and was owned by the central government and state pension fund as of 1995. In 1994-5, the government's control rights alternated between APV Rt and the MOF. OTP's core business has been retail banking, although it had a 7.6 percent share of the commercial credit market in 1993. It also posed interesting corporate governance dilemmas because of its size and history. Before 1987, it was a *de facto* second banking tier, and by the mid-1990s it accounted for 65 percent of the retail banking market, 90 percent of housing loans, and 97 percent of banking services to municipal governments (overall, government borrowing comprised 55% of OTP's assets). Here, Hungary fortunately avoided the pattern of abuses that occurred elsewhere – such as Slovakia, which used a similar institution for "telephone" directed lending under Meciar, and now has a portfolio in which 30-40% of loans are bad. OTP did, however, engage in some directed housing sector loans, and sought subsidies to cover its losses.

Its style of privatization was distinctive. First, Minister of Finance Bokros decided to divide the functions of CEO and Chair of the Board of Directors, which were up to then held by the same person, in order to weaken the management. Unlike the other transactions, the OTP privatization was intended to *disperse* ownership because of the fear that OTP's vast client base and branch network (430 branches at the time) would create a privatized monopoly. Thus, OTP was not sold to a strategic investor but floated on the stock market in two tranches of between 25 and 30 percent each, in 1995 and 1998. The government retains a "golden share" as well as indirect minority shares through SOEs and the state pension fund. Most of OTP's ownership is dispersed among international equity holders.

Budapest Bank, 1995: This was the first privatization of a majority stake in one of Hungary's large commercial banks (one of the SOCBs created in 1987, and in the top five as of 1995).[85] Unfortunately, the government found itself in a weak bargaining position at the time. Apparently, at least one viable offer from a major international financial entity (Credit Suisse First Boston) had dried up, and the government was facing increasing pressure internationally, and due to its balance of payments problem, to move on bank privatization. As a result of this, and the alleged inattention of the senior MOF staff, the government entered into a much-criticized "giveaway" deal that yielded a far lower purchase price, and far more guarantees extended to the buyer, than most outsiders considered acceptable. The state treasury did no better than break even on the deal, since the MOF had hurriedly (and without legal authority) injected capital into the bank, in an effort to strengthen its bargaining position, in the amount of 12 billion HUF (equal to the eventual purchase price). GE Capital and the other major investor, the EBRD, received "put" options to sell their entire combined 60% stake at a predetermined price, thus protecting

[84] Oszabo and Vajda (1999).

[85] Previously, Budapest Bank had suffered significant losses and during the consolidations, it was said to have made a dramatic (and controversial) change in its provisioning policy, keeping reported problem loans and provisions artificially low. It did so, apparently, to avoid having the MOF take a controlling stake through a recapitalization of the bank – just the opposite of what some of the less reputable bank managers were doing at the time.

themselves against losses. Moreover, the main buyer, GE Capital, was only a financial investor without "strategic" or reputational risk in the banking sector. The government attempted a renegotiation of the terms later, but this added further to its overall costs to the treasury.[86] Still, the bank and the management team brought in by GE Capital appear to be well-regarded.

Magyar Hitel Bank (MHB), 1996: MHB, another major commercial bank, was sold to ABN-Amro. There were a few interesting features in this privatization. First, it offers a prime illustration of the risky and subjective nature of valuations in this context: an Austrian bank offered 1 (one) HUF, while ABN-Amro offered 14 billion HUF and promised a $100 million capital increase. Second, while most SOCB managers used their political connections and collected large salaries, with no incentive to privatize (indeed, every reason to delay), MHB's CEO accepted a minimum salary plus the equivalent of stock options, as an incentive to maximize the bank's privatization value. Last, although the bank was profitable in 1996 just prior to the sale, since then it has experienced a huge rise in operational costs and signficant losses. These events are subject to varied interpretation, and indeed one person who was close to the transaction said that parts of the story are "untellable" for political reasons.

Kereskedelmi es Hitel Bank (K&H), 1997: K&H, another major commercial bank, underwent what was probably the most controversial privatization. The incumbent management apparently succeeded in gaining control of the privatization process and turned it to their personal benefit. Part of what attracted attention was the presence, as CEO of K&H, of Janos Eros, an able and well-connected survivor of the communist elite, whom the government had appointed to lead K&H into privatization. Eros had been CEO of AEB, a small bank that apparently suffered a combination of loss-making political lending and looting by management, until it became insolvent and was sold to a Gazprom affiliate. K&H also had a "political portfolio." This included support for party "foundations" (essentially campaign warchests), consulting agreements favoring political figures through intermediary companies, and questionable loans to parties or party affiliates. K&H was cited in audits for increasing losses, high costs, and significant departures from its business plan.[87]

In the preparations for privatization, a dispute arose between K&H management, which wanted the privatization done as a share offering, and the government (APV Rt, NBH, and the MOF), who favored a limited tender for sale to investors. The K&H proposal would have fragmented outside shareholdings and led effectively to control by insiders. The government's point of view prevailed. During the government's pre-selection of bidders, the best-known applicant, ING of the Netherlands, apparently was kept out of the bidding at the insistence of K&H management, who feared the group aimed to restructure and fire the incumbent managers. Two bidders were chosen for the short-list, including a Belgian-led consortium (Kredietbank/Irish Life) that came in with a very high price and was eventually chosen. Allegations arose that K&H management was manipulating the process, and that the MOF, which supervised the privatization process, was either colluding with them or was simply not being vigilant. During the process NBH withdrew from the K&H privatization, and when APV Rt refused to go along with the MOF, its chief was fired and replaced by an ambitious official who helped see the deal through, and was apparently awarded later with promotion to a higher office.[88]

The Kredietbank/Irish Life group purchased a minority share for more than 500% of its nominal value at the time, and undertook to provide a $60 million capital increase. The

[86] *Id.*
[87] Oszabo and Vajda (1999).
[88] *Id.*

transaction also included a subordinated loan from the EBRD, subsequently capitalized. Controversy arose because the high price offered by the winning bidder also came with a share options package that was unusually favorable to the incumbent management.[89] Both the distribution and the pricing and amount of the options violated the privatization law. The share purchases were also apparently leveraged with funds borrowed from the K&H group itself. Eros and some of his colleagues (along with a coterie of celebrities and politicians, some acting as fronts) exercised the options and then sold their shares to a brokerage affiliated with K&H for a markup of more than 250 percent – netting Eros alone some 660 million HUF, essentially overnight. The sale to the brokerage also apparently included its agreement to hold the proceeds for an unusually high guaranteed return. After the privatization deal became effective, the bank incurred increasing losses and its shares languished on the stockmarket.

Some months later, the EBRD, having become a part-owner, launched a legal examination of these dealings. Investigations by government auditors and the Chief Prosecutor's office followed, revealing irregularities and leading to recommended changes in privatization-related regulations. The banking supervision (then called the Financial and Capital Market Supervision) later filed a criminal complaint against the brokerage and slapped it with heavy fines. The management of K&H itself is widely believed to have been engaged in self-dealing and worse, but no legal action has been taken against it. Later, the Kredietbank consortium apparently determined that it should exercise tighter control. In order to do so, it increased its ownership share from 28% to 60%, buying out the government's remaining (directly held) equity, and began planning a restructuring to deal with losses of over four billion HUF. Eros resigned as CEO in late 1998, probably under pressure from more vigilant owners in the Kredietbank group, and was removed from his seat on the bank's supervisory board in the spring of 1999. The MOF has also faced criticism for, at best, being too busy to monitor bank privatization deals carefully, and worse, of overlooking collusion within its ranks.[90]

As has been suggested, these transactions – messy as they were – helped create arguably the strongest financial sector in the transition region. Together with the earlier reforms, they produced a cumulative effect. The impact of these reforms to date is explored in more detail in the next chapter.

---

[89] Normally in this context, share purchase options were spread among management and staff, but in the K&H deal, an option package amounting to 5 percent of the bank's shares was distributed so that nearly a third went to Eros and another third to the other 20 top managers.
[90] *Id.*

Table 1: Financial Sector Corruption in Hungary: Summary of Problems and Responses

Problem	Stakes	Causes	Responses	Outcomes
Distorted Credit Allocation: *Loans for bribes* *Crony lending*	Connections win, smaller firms and entrepreneurship lose Credit supports self-dealing, not value-creation or growth Bank ties to conglomerates, networks, state strengthen Finance is politicized Banks weaken, failure (harming depositors) is more likely	Cronyism: political-business networks shielded by weak transparency, competition State or financial-industrial group control, outside owners dispersed, weak monitoring Distorted incentives: share-holder value a low priority Weak internal checks and balances (banks, firms)	Political and economic liberalization: bank privatization, FDI Untangle networks: pluralism, transparency, banking law, FDI Incentives, checks: banking regulation and bankruptcy law	Banks stronger, mainly private and foreign-owned Value-creation incentives stronger than self-dealing, rent-seeking Corruption scandals and episodes, but not endemic, no kleptocracy Credit still large-firm and govt-oriented
Failed Corporate Governance: *Diversion of assets* *Self-dealing* *"Pocket" banks*	Insider control wins, owners (state and private) lose Assets are stripped, liabilities become public responsibility Shaky new firms go bankrupt, weakening the banks Potential for oligarch financial-business networks, kleptocracy Investors stay away	Early privatization: no legal controls, weak state property mgmt Ineffective ownership incentives, corporate governance Dispersed shareholding, weak monitoring Distorted incentives: theft, rent-seeking more profitable than competition, value-creation	Ownership change: enterprise privatization, FDI Corporate governance: law, incentives, competition, FDI Incentives, checks: rule of law, transparency, company law Bank licensing limits	Large enterprises mainly private and foreign-owned Improved industrial production, economic growth Corporate governance improved Networks more transparent, less extensive, but corporate groups and cross-ownership still important
Administrative fixes, manipulation: *Rigged sales and auctions* *Bailout profiteering* *Politicized bank supervision*	Cronies win; investors, treasury, general public lose Assets do not find efficient uses, growth potential lost Privatiz/liquidation revenue lost, more/bigger bailouts More shaky banks, bank runs, bank failures Public debt increases	Cronyism: political-business networks shielded by weak regulation Weak internal checks and balances (state) Weak public governance bodies, watchdog organizations Inadequate banking, accounting, bankruptcy law	Stronger state property and privatization management Incentives, checks: bankruptcy/accounting law, civil service reform, pluralism Bank supervision strengthening, EU approximation Credible end to bailouts	Banking supervision being upgraded, but still problem of "political" banks Credible competition and exit Massive enterprise/bank debt resolved, but large public debt No general bailouts, but Postabank

Chapter V: Outcomes, Aftermath

After initially deepening its transition crisis as well as its murky financial structure, Hungary's reforms placed its economy in a comparatively quite strong position by the late 1990s. Growth in 1999 stood at 3.7 percent, inflation at 10%, and the position of the financial and enterprise sectors much improved. Hungary remains one of the most attractive investment destinations in Eastern Europe, despite some mixed signals about economic policy sent recently by the coalition government of Prime Minister Viktor Orban.[91] One of the driving forces of this economic success is the improvement of systemic governance that we just reviewed. Restructuring and reform tipped the balance of incentives away from corrupt enrichment towards market competition.

This chapter assesses the outcomes of Hungary's reform efforts, presenting evidence concerning the current state of financial governance, as well as the major unresolved issues. The next chapter presents the broader lessons of this experience.

Restructuring and Privatization Outcomes

Banks:

The bank privatizations in Hungary are credited with securing a strong financial sector. Evidence of this strength includes: profitability, private capital injections, an increasingly wide range of products and services, investments in productivity enhancements such as IT, fierce competition and falling margins, and an influx of non-bank institutions. Increasing competitiveness in financial services is noteworthy because size and market domination increase political influence, hence the likelihood of distortion. While the three banks spun off from the monobank still accounted for more than 75 percent of banking system assets as of the end of 1993, by late 1997, the three largest banks (OTP, MKB, and K&H) held 40 percent of banking sector assets. OTP's share in retail deposits fell from 95 percent in 1987 to about 50 percent in 1997. This suggests as well that banks are seeking new markets, especially retail services. Greenfield banks established by foreign investors have performed best, followed by privatized banks, which have improved their profitability but still have high average operating costs. The privatized banks improved the quality of their portfolios, bringing qualified assets down from 29 percent of the total in 1993 to 7 percent in 1998, and increasing their risk-weighted capital adequacy ratios from 7 to 13 percent over the same period.[92] (See Table 2) These figures also strongly suggest major improvements in governance, including vastly diminished political control (and with it, a decrease in corruption). Despite some losses and portfolio weakening, the Hungarian financial sector rode out the Russian crisis without major damage.[93]

Hungary was lucky, in a way, to have taken advantage of a window of opportunity for bank privatization that was open only from 1995 to 1998. By the end of this period, foreign ownership of the banking sector reached 60% (70% in brokerages and 90% in insurance companies), and total private ownership of banks 80%. The state kept direct shareholdings in the strategically most important retail banks (OTP and Postabank), but is in the process of divesting

---

[91] Economist Intelligence Unit (2000), "Hungarian Economic Review," *The Economist*, May 2000.
[92] This is strong, but still less than the CAR of 17 percent for medium sized (maily greenfield) private banks.
[93] Karvalits (2000), World Bank (1999), Anderson and Kegels (1998).

these. Local governments and the state pension fund have retained small minority holdings. Quickly reducing state ownership of the sector to about 20 percent, and continuing to push it below that, seems to have tipped the balance away from widespread political intervention. Banks now cannot normally expect bailouts, at least for purely political reasons.

Table 2: Indicators of Financial Sector Governance in Hungary

Year	Bank Ownership: State[94]	Bank Ownership: Foreign[95]	Banks: Unit Profit-ability[96]	Banks: Problem Assets[97]	Banks: Interest Rate Spreads[98]	Government Share in Credit Stock[99]	Top Five Banks' Market Share[100]
1989			58				85%
1990			50				80%
1991	40.5%	15.8%	22	4.1%		61.3%	72%
1992	39.1%	18.5%	0	8.5%		65.2%	70%
1993	67.7%	12.4%	- 102	20%	10%	70.7%	68%
1994	65.8%	16%	10	11.5%	7%	71.5%	62%
1995	41.8%	35.7%	18	7.4%	5.5%	72.6%	58%
1996	31.1%	49%	20	5.4%	5%	69.4%	60%
1997	20.4%	60.6%	15	2.9%	3%	62.7%	55%
1998	21.7%	60.4%	- 38	4.9%	2.5%	61.5%	52%
1999			10	4.2%			52%

Indeed, Hungary's banking sector might be falling victim to its own success. First, the country is widely thought to be overbanked, which has squeezed bank margins and may lead to a shakeout. Still, it is a far cry from Russia, for example, where "free" licensing resulted in an explosion of new banks, many of them either undercapitalized, fraudulent, or both. Hungary limits issuance of banking licenses (with the total number recently at 42), and new investments face rigorous entry requirements, including an official investigation of the owners and sources of capital.[101] Another question arises concerning Hungary's high required capital adequacy ratio, which averaged over 17 percent during 1996-8 and was 14 percent in 1999. Setting the ratios this high is said to be justified by the fierce competition in the banking sector including international banks. However, this may be contributing to the fact that, although resource allocation by the banks stopped deteriorating and began improving during the mid-1990s, credit to smaller borrowers (e.g., households and SMEs) remains tightly constrained.[102]

---

[94] By registered capital. Source: Hungarian National Bank, Annual Reports.
[95] By registered capital. Source: Hungarian National Bank, Annual Reports.
[96] Estimates of Return on Equity. Source: Ministry of Finance.
[97] Assets classified as substandard, doubtful, and bad. Source: Hungarian National Bank, Annual Reports.
[98] Estimates at the start of each year, based on data presented in World Bank (1998).
[99] Net credit to general government, central and local, as share of total domestic credit stock at year end (1998 data preliminary). Source: Hungarian National Bank, Annual Reports.
[100] Estimates based on NBH data presented in Karvalits (2000).
[101] Moreover, bank supervision officials must approve any election to a bank board or to management, as well as major operational changes. Supervisors are said "frequently" to use this authority to suspend such decisions, and can sanction corporations and individuals where regulatory standards are transgressed (e.g., by dismissal, or by barring someone from becoming an officer of any other bank).
[102] Another factor is that credits to government (treasury bills) continue to make up some 60 percent of banking sector assets.

Enterprises:

As the analysis earlier in this study suggests, the quality of financial sector governance clearly depends on additional factors that define the business and institutional environment for finance. One such factor is the extent of enterprise privatization and restructuring. The state's interest in supporting particular enterprises tends to diminish as these firms are taken private and restructure for competition. Also, banks that have some state ownership also usually have, sitting on their boards, representatives of SOEs and other state agencies with specific interests in the outcome of credit allocation decisions. As firms are privatized, these state representatives are withdrawn, hence informal pressure to direct credit to these SOEs eases. Last, the influx of FDI plays a major role.

Box 7
Enterprise Performance Indicators in Hungary

New research provides a revealing picture of private sector and foreign investor participation in Hungary's enterprises and banks:[103]

Ownership: Large manufacturing firm ownership (top 1500 exporting firms in 2000) --
Foreign investors = 46.6%
Hungarian firms = 17.9%
Hungarian individuals = 30.4%
Other (including the state) = 5.1%.

Turnover: (top 1500 exporting firms, 2000) by ownership category—
Foreign-owned firms = 81.7%
Hungarian-owned firms = 9.3%
Hungarian individuals = 6.6%
Other = 2.55.

Value Added: foreign-owned firms produced approximately 57% of all value added in 1992-6 (panel data on over 6400 firms).

Financing sources for Hungarian firms (average ranking by use, from 1=low to 5=high):
Retained profits = 3.4
Loans from Hungarian-owned banks = 2.18
Capital from foreign owners = 1.7
Loans from domestic owners = 1.67
Trade credit = 1.46
Loans from foreign banks (located abroad) = 1.15
Equity markets = 1.1.

The same survey of financing sources showed that local firms faced tough financing constraints:
- Over 30% of firms reported receiving no credit
- Three other groups of firms, representing 20% each, reported loans-to-assets ratios of: under ten percent, 10-25 percent, and 25-59 percent.

Hungary has aggressively privatized since 1995, and this has included divestment of major shares of the telecoms, banking, utilities, and media industries. Privatization raised some $6 billion in receipts – a significant boost to Hungary's public debt balance (though it remains a large debtor) – and the private sector currently accounts for approximately 80% of GDP (up from

[103] Source: Istvan Toth.

29% in 1989), one of the highest shares in region. Ownership will remain mixed, as the government plans to continue its long-term majority ownership in 109 companies, and to maintain veto rights on the sale of 50 additional companies under "golden share" legislation. The stock of FDI reached almost $18 billion by the end of 1998, more than one-third of GDP, and foreign investors owned over 51 percent of registered capital in manufacturing firms by 1996. As in the banking sector, the key hoped-for benefits of FDI in enterprises include restructuring, governance, and profitability. The firms with controlling foreign investors as of 1992 performed best: between 1992 and 1997, their sales tripled, they invested heavily in new assets, and their overall employment rose by 40 percent. Firms with minority foreign shareholders in 1992, as well as those acquired later, performed almost as well. (World Bank 1998) This supports the observation that "for resource-poor transition economies privatisation to foreign strategic investors is the single most important question of the ownership revolution." (Mihalyi 2000) (Box 8 and Table 3 present relevant data on the enterprise sector.)

FDI tends to strengthen corporate governance by loosening local networks of ownership and control, and improving standards. Recent empirical studies in Hungary show that, while domestically-owned firms are still often connected to overlapping local ownership and market networks,[104] this is not at all true of firms with foreign ownership. As we have suggested, cross-ownership is often far from benign. For example, research in Hungary suggests a link between the amount of enterprise debt held by a bank, the size of its provisions against doubtful loans, and its level of participation in enterprise governing boards.[105] This and earlier surveys also showed a proliferation of state connections, including both ministry representatives and members of parliament sitting on enterprise and bank boards.[106] The evidence also suggests that the large influx of FDI has been dissolving many of these networks. Foreign investors want to make things transparent; many do not trust the suppliers and in some cases the banks related to the local firms that they have acquired. Thus, of the largest 500 firms now in Hungary, each tends to be owned entirely by a single corporate group – and this applies especially to foreign-owned companies. On average, each is about three-quarters owned by one corporate entity, a comparatively heavy ownership concentration. Moreover, foreign firms have a stronger record of debt payment, contractual discipline, and tax compliance than local firms. They also represent a disproportionately large share of turnover, value-added, and growth among partner firms.[107] This behavior tends to spill over into the practices of local firms: their tax compliance and contractual discipline have improved substantially. (Toth 1999a and 1999b, Toth and Semjen 1999)

The competitive environment and the threat of bankruptcy have also played an important role in imposing financial discipline and forcing firms to restructure. Widespread management-initiated downsizing, including the shedding of large portions of the labor complement, evidence

[104] This is less true now than previously – except for small firms -- and never as pervasive as earlier suspected. Also, while some analysts of Hungary's early transition period saw it as plagued by intricate (and shadowy) webs of cross-ownership, others say that corporate networks have never been as dense in Hungary as elsewhere, e.g., Poland and the Czech Republic (as well as Germany). Of course networks, especially social ones, are unavoidable in a small country such as Hungary. This is desirable in many ways as a check on opportunism and corruption.
[105] The temporal order of these events – hence, whether sitting on corporate boards encouraged banks to extend easy loans, or in fact was part of banks' efforts to improve their monitoring of debtors – is unclear.
[106] Although the 1998 Code of Ethics of Public Officials prohibited officials from sitting on corporate boards in most circumstances.
[107] Additionally, the positive impact of concentrated ownership and high levels of foreign ownership on enterprise restructuring has been demonstrated in empirical surveys in Eastern Europe and several former Soviet countries. (Djankov 1999)

this. Gambling on bailouts has become costly, and closure a real risk. Paradoxically, one potential danger posed by this enterprise restructuring, especially given the now-prevalent model of universal banking and the continued lack of transparency in many corporate groupings in Hungary (and other countries of the region) is the emergence of financial-industrial groups or conglomerates. This is a continuing concern, as discussed below.

Table 3: Indicators of Corporate Governance in Hungary

Year	**Manufacturing Firm Ownership: Government**[108]	**Manufacturing Firm Ownership: Foreign**[109]	**Industrial Production**[110]	**Enterprise Bankruptcies: Reorganizations**[111]	**Enterprise Bankruptcies: Liquidations**[112]	**Public spending, share of GDP**[113]
1989			100			28.9%
1990			90.7			29.5%
1991			74.1			32.1%
1992	64%	20.5%	66.8	Initiated: 6,669 Closed: 2,703	Initiated: 12,118 Closed: 4936	35.5%
1993	40.8%	30.9%	69.5	Initiated: 1,874 Closed: 1,924	Initiated: 9,835 Closed: 5,115	38.7%
1994	30.9%	37.1%	76.3	Initiated: 268 Closed: 469	Initiated: 8,195 Closed: 4,149	32.3%
1995	20.9%	46.7%	79.7	Initiated: 173 Closed: 205	Initiated: 9,115 Closed: 5,457	25.1%
1996	15.3%	51.1%	82.4	Initiated: 94 Closed: 89	Initiated: 10,475 Closed: 6,842	23.1%
1997			91.6			23.4%
1998			103.1			

Unfinished Business[114]

The privatization of Hungary's state-owned banks and enterprises, along with the accompanying macroeconomic and institutional reforms, represents an extraordinary success story in many respects. It is always difficult, and frequently dangerous, to take opportunities for enormous aggrandizement and enrichment away from powerful people. Changes of this kind often involve trade-offs in which powerful groups or figures who cannot be dislodged against their will are in effect "bought off" in the interest of larger benefits to the public. We have done little more than allude to these trade-offs, since their sensitivity has largely kept them out of the public record. Hungary's political transition in 1989-90 apparently involved deals of this kind. It is also quite probable that enterprise and bank privatizations involved official tolerance of (in

[108] Source: World Bank (1998).
[109] *Id.*
[110] Initial year = 100. Source: Toth (1999).
[111] "Initiated" = aggregate of those filed and those court-announced. Source: Bonin and Schaffer (1999).
[112] *Id.*
[113] "Public" includes state capital formation and budgetary expenditures. Source: Toth (1999).
[114] This discussion relies substantially on findings from interviews in Hungary.

some cases active participation in) cronyism, asset-stripping, and other forms of corruption. One way in which powerful interests secure continued benefits to their allies is through the state's retention of ownership in commercial entities that can channel these benefits in the right direction.

Some recent scandals in Hungary illustrate this dynamic at play, suggesting that the reform and privatization processes left important business unfinished and deferred major governance challenges (and tradeoffs) to the future. Currently, the Hungarian Development Bank (MFB) is reputed to be the most corrupt bank. This is due partly to its heavy losses, its financing of large non-competitive infrastructure tenders, and the fact that its legislative charter protects it from both public scrutiny and regulatory oversight. However, the *Postabank* affair of 1998 is by far the most notorious example of financial corruption in recent years. The Hungarian postal savings bank became a political tool during the 1990s until it was driven to the brink of failure, and then recapitalized and restructured by the current government amid scandal and recriminations.

Postabank was created in 1988 to compete in retail banking with OTP, and initially was wholly owned by the Hungarian Postal Department. In 1990, shares were sold to a number of interests, mainly Hungarian SOEs and the Austrian state postal bank, and in 1994, the state pension fund acquired a 20% share. As of 1994, the government held only 30 percent of Postabank's shares directly, and as a result the bank was officially considered "privatized." However, the government owned another 50 percent of Postabank indirectly, through the pension fund and SOEs. By the late 1990s, Postabank was among Hungary's top ten banks, with 60 branches, 60 small outlets, access to the postal network, and an estimated market share of 7% of retail and 3% of corporate business.[115] It became clear by 1995 that neither the private owners nor any of the state entities were exercising effective corporate control. This enabled the managers to adopt a reckless strategy of rapid growth, and opened the door for some of the state owners to coopt the bank for their benefit and that of their political allies. Adverse findings from audits and government pressure to shore up its capital base only intensified the bank's "gambling" behavior.

Postabank's CEO, Gabor Princz, was cut from the same "old school" mold as the communist holdovers of the traditional left (including some in the Horn government). Although he was most clearly associated with the then-ruling coalition, he is widely known to have had connections to all the major parties and the media. To ensure the desired influence and leverage with all of these power bases, Princz apparently directed an estimated 428 million HUF in preferential loans (some interest-free, others at 10% interest rates rather than the then-standard 30%) to a list of such "VIPs." These loans, perhaps as expected, were largely not repaid, and Postabank began incurring significant losses. Another method of extracting money from Postabank involved directing procurements for the bank's computer and communications equipment to politically-connected suppliers who overinvoiced for the goods and paid kickbacks to officers of the bank.

Postabank management responded to distress with a combination of lobbying for state guarantees and various frauds to cover up its capital shortfalls.[116] When the government did intervene in 1997, the proceedings apparently involved only a handful of top cabinet officials and

---

[115] "Hungarian Economic Review," *The Economist*, May 20, 2000.

[116] E.g., capital increases via registered shares and bond issues purchased by client SOEs and others, financed by loans from Postabank itself, also acquiring another bank and using its leverage to extract guarantees, thus pushing the affiliate bank into distress.

were shrouded in secrecy. Subsequent internal analysis showed "doubtful" and "bad" loans rising from two percent of total loans in 1996 to 60 percent in 1998 (before cleanup). Weak corporate control resulted in a failure to rein in these abuses and to reassert prudent banking practices. An equally serious failure of supervision by the bank regulators kept this activity from being discovered and corrected. At a minimum, the banking supervision acted only after an unjustified delay. Worse, there seems to be virtual consensus that this failure of supervision arose from pressure on officials to "look the other way."[117]

Solving the Postabank problem took some three years, over 185 billion HUF in state funds, and a change in government. The Horn government was unwilling or unable to get at the root of the problem. It undertook repeated interventions and injections of state money, even after pressuring Postabank to shore up its capital position. There were several attempts by internal auditors and outside parties to convince the government to address an increasingly dangerous situation, in which reckless and corrupt bank management threatened to bring down Postabank and a large mass of ordinary depositors with it. (A run on the bank occurred in 1997.) One of these was a direct plea by the U.S. and UK ambassadors to Prime Minister Orban shortly after his election in 1998. Mr Orban faced a painful dilemma. Taking action meant acknowledging the problem and removing Mr Princz, whose quiet but substantial financial support to the ruling FIDESZ (Federation of Young Democrats) coalition gave him leverage over the Prime Minister. Failing to act would bring on a financial catastrophe. Orban hesitated for a time, but had little choice and decided to act within weeks of his inauguration. An official investigation was launched, and Princz called in for questioning. In August 1998, Princz was forced to step down as head of Postabank and face likely prosecution. He soon took refuge in Austria, returning briefly in Spring 2000 for an investigatory hearing.[118]

The Postabank cleanup took place in late 1998. Audits showed major losses, fraudulent transactions, coverups through falsified balance sheets, lending decisions essentially dictated by CEO Princz, and negative capital. Criminal investigations were still underway as of mid-2000. Almost all of Postabank's approximately 35 top managers were replaced, the bank's structure reconfigured (including the establishment of internal professional checks on loan approvals), and its activities and accounts kept under tight scrutiny. Capital replenishments resulted essentially in a nationalization of the bank, with the government holding over 99 percent. Officials said that Postabank's privatization was slated to begin in late summer 2000.

Current Governance Concerns

We have discussed the important effects of privatization, foreign investment, strategic owners, and well-regulated banks on the integrity of the financial sector. There are still some pressing questions about the institutional framework for the financial sector. The National Bank of Hungary appears to be one of the strong points. Amendments to the central bank legislation in 1996[119] significantly increased its autonomy, first, by requiring parliamentary hearings on the President's proposed appointee to head the NBH and narrowing the grounds on which the appointee's six year term can be terminated. Second, the amendments specified that NBH could extend credits to the central budget only in exceptional circumstances and within strict limits, as

[117] *Id.*
[118] State Audit Office Report, 1999.
[119] Act CXXIX of 1996, amending Act LX of 1991 on the National Bank of Hungary, effective January 1, 1997.

defined in the legislation – thus further removing the central bank from direct credit allocation and public debt management.

Hungary also appears to be well advanced on the legal "harmonization" required to ready its financial sector for EU accession. Liberal treatment of FDI and bank privatization are especially important benchmarks for EU entry. Hungary is said to be two to three years ahead of other transition countries in this regard. EU accession will bring Hungary into a "single license" regime where its institutions will be required to meet prudential standards applicable in all member states and to be effectively supervised. However, Hungary still has important improvements to make in bank supervision and some other areas prior to accession (see below). The European Commission continuously monitors Hungary's progress on these and other EU accession benchmarks, and has recently established a framework for additional monitoring of progress by the 12 "pre-accession" states among themselves.[120]

Table 4: Comparative Data on Governance and Corruption in Transition[121]

Governance Issue	Hungary	Czech Republic	Poland	Russia
Sale of legislative votes or decrees a problem[122]	12% of firms agree	18% of firms agree	15% of firms agree	38% of firms agree
Sale of court decisions a problem	6% of firms agree	14% of firms agree	18% of firms agree	28% of firms agree
Election campaign finance nontransparent	4% of firms agree	6% of firms agree	10% of firms agree	24% of firms agree
Public sector patronage a problem	6% of firms agree	16% of firms agree	28% of firms agree	30% of firms agree
Bribes to avoid taxes, regulations a problem	8% of firms agree	10% of firms agree	24% of firms agree	32% of firms agree
Regulatory decisions consistent, predictable[123]	42% of firms agree	50% of firms agree	50% of firms agree	60% of firms agree
Senior management time spent with officials on rule interpretation	8% annual mean	5% annual mean	9% annual mean	12.5% annual mean
Paying bribes	64% of firms admit	66% of firms admit	66% of firms admit	68% of firms admit
Can take official rule-breaking to supervisor	36% of firms usually can do so	24% of firms usually can do so	36% of firms usually can do so	32% of firms usually can do so
Receive government subsidies[124]	21% of firms	17% of firms	17% of firms	17% of firms

International governance mechanisms of this kind can be important in encouraging reform, spurring governance-based competition among states, and imposing disciplines that enable local reformers to make credible commitments to pursue change. Another example is the EBRD, which has invested more in Hungary than any other country. The bank takes equity

[120] Horvath and Szamboki (2000), Wagstyi, Stefan, "EU Accession States Urged to Co-operate with One Another," *Financial Times*, May 22, 2000, p 7.
[121] Estimates based on data reported in Hellman et al (2000).
[122] I.e., surveyed firms identified the matter as a "moderate" or "major" obstacle: rows 1-5 of this table.
[123] I.e., firms "fully" agreed, agreed "in most cases," or "tend to agree" with this as it affects them.
[124] Including tolerance of tax arrears.

positions in banks and enterprises. At the same time, it advises on relevant local laws and uses them to protect its shareholder rights – in principle, this fosters good corporate governance.[125]

There are concerns, however. Some have arisen over weaknesses in the capability and autonomy of the Hungarian Financial Supervision Department (and its predecessor agencies). The safeguards in place, given a strong legal basis in the reformed banking law of 1996[126] and subsequent amendments, notably failed during the Postabank affair. The law provides for the department's fiscal autonomy and its formal accountability to parliament, although it is legally and financially supervised by (hence in fact subordinate to) the MOF. The department president is subject to appointment and dismissal by parliament (upon the Prime Minister's nomination and in theory for a 6 year term) – hence the fact that there have been seven department presidents in the last nine years. Furthermore, parliament decides on the management of the department's budget, which can undermine its formal status as fiscally self-supporting. There is also reason to believe that Hungary's delay in exposing its banks to restructuring, privatization, and competition made these tasks more difficult, since the lobbying power of bank (and enterprise) managers increased in the meantime.[127]

An additional difficulty for the supervision department arises from the fact that it does not yet have "consolidated supervision" capacity. This would provide mechanisms for bringing under its supervision affiliated corporations – of lenders and shareholders on one side, and debtors and firms floating shares on the other. The law requires notification of any acquisition of more ten percent of shares in a bank, and prohibits any non-financial corporation from acquiring more than 15 percent. Supervisors need to be able both to enforce these provisions and to look out for risks that are not always in banks but may be in their affiliates. The sometimes complex interconnections among Hungarian firms and financial institutions can pose challenges here, and conglomerate behavior is still much in evidence. EU standards require consolidated supervision, but two local events convinced the Hungarians to move on this front: the local stock market crash during the Russian crisis of 1998, and the failure of Realbank, now in liquidation, whose corporate structure effectively hid high risks from the supervisors. Connected lending is also an issue, since Postabank and Realbank both created their main problems this way, and hid them from scrutiny by means of complicated ownership structures. Recent reports on progress towards EU accession suggest that the Financial Supervision Department is gaining strength.[128]

Corporate governance, as well as the internal culture and incentives of banks and enterprises, still raises some question marks. Privatized banks needed to make a cultural transformation from the old ways, and the cost of this, especially in large institutions, is high. Greenfield investments avoid the problem of transformation, and tend to be smaller and more easily manageable as well. Hungary's transition strategy did not place the highest emphasis on new start-ups. The financial sector still struggles with the paramount power of managers, and a culture of tolerance for conflicts of interest and self-dealing. The sheer fact of predominant private ownership and control does seem to make an important difference. One of the most important improvements is that government shareholdings in the banking sector are now insignificant enough not to cause major problems in bank governance. Reliance on foreign investors to improve the banks has justified itself in some respects, as discussed previously. This also has advantages from a prudential viewpoint. Due to the fear of corruption, some tie their local bank managers' hands, imposing low lending and investment limits, and referring most

---

[125] "Reluctant Graduates," *The Economist*, May 20, 2000, p 102.
[126] Act CXII of 1996 on Credit Institutions and Financial Enterprises.
[127] Mizsei (1997), interviews.
[128] World Bank 1998, Gero and Vedres (1998).

substantive decisions to the senior level in the home country headquarters. Foreign banks also bring aspects of their home country regulation with them – home country regulators to varying degrees "look over the shoulder" of the local regulators (this includes regulators from EU member countries, until Hungary comes within the EU rules for cooperation in banking supervision). Additionallly, when their local partners fail, the foreign banks are required to have sufficient capital to pay for their mistakes, thus ensuring that these banks will not make claims on the Hungarian treasury.

Public administrative and legal institutions have strengthened considerably (see Box 8), but a major concern is still the quality of watchdog institutions in Hungary. The press has not played as big a role as it might, due in part to the state of its development and due in part to government interference. For example, investigative journalists who published a series of expose articles on the Postabank case were prosecuted for criminal bank secrecy violations. They were exonerated but warned that there would be serious trouble next time. There is continuing controversy, including international statements of concern, about the majority coalition's domination of state positions on broadcast media supervision boards.[129] Accounting firms and professionals have also failed to be quite as constructive as they could be. Most major Western accounting firms set up offices in Budapest during the early 1990s, some of them choosing prominent old-school Hungarians to head their offices, and applying more lax professional standards than in the home country.[130] Some corruption apparently continues on a lesser scale in and around the financial system but overall there has been a notable improvement in governance practice. (Table 4 presents comparative data on the equality of governance in selected transition countries).

[129] "Hungarian Premier Rejects Accusations about Media," *RFE/RL Newsline*, March 16, 2000.
[130] Interviews.

Box 8

Public Integrity Institutions in Hungary

Public governance institutions such as the civil service, the judiciary, and the audit institutions have decisively improved since 1989, but still suffer from important weaknesses. The civil service in Hungary has been regarded as generally unprofessional and politicized, since newly installed governments – facing few restraints in practice—change most upper level personnel in the administration in order to reward their party faithful. This brings into the civil service inexperienced personnel, adding to longstanding problems of low pay and demoralization. Some important steps have been taken in recent years, however, including enactment of the Code of Ethics of Public Officials, effective January 1, 1998; an average civil service pay increase of 15 percent in 1998; and the introduction of examination requirements for 10,000 management level civil servants in 1999. Current plans envision a comprehensive review of salaries, performance pay, and career development and training programs.[131]

The Hungarian judiciary has made important strides during the 1990s. From a conservative and politically subordinate branch that was unprepared for the transition, it has gained a significant measure of autonomy, capacity, and legitimacy. The reformed constitution of 1989 embodied the mandate for judicial independence in a regular court system with a Supreme Court at its apex, and a Constitutional Court. The formal autonomy of the system has improved significantly with recent legislation shifting administrative responsibility for the courts from the Ministry of Justice to a 15-member National Judicial Council. The Supreme Court came under heavy political pressure in the mid-1990s, but appears to have emerged with its autonomy and legitimacy intact. The numbers of judges and staff, the quality of their support systems, and judicial training opportunities have increased, and a new intermediate level of appeal is being phased in between 1999 and 2003. Procedural reforms have also been implemented to simplify the process and to improve the speed and efficacy of judicial proceedings. Simultaneously, however, the numbers of cases at each level has increased, with criminal trials requiring on average more than a year, and backlogs growing at the Supreme Court. A reason for the latter is a consequence of one the system's strengths: the availability of judicial review of administrative decisions, along with a recent streamlining of the administrative appeals process. Efforts are underway to increase the capacity of the Supreme Court and to shift some of this jurisdictional load to the new appeals level.[132]

Hungary has a panoply of legal provisions and initiatives dealing directly with corruption, but has not established a central anti-corruption body, instead relying on constitutional checks, its judicial system, and its financial control institutions. The Penal Code provisions on corruption offenses were strengthened in 1999, and a comprehensive review of legislation is underway for purposes of identifying weaknesses and loopholes that may contribute to corruption. Anti-corruption units have been set up in the police and border security departments, and existing or *ad hoc* parliamentary commissions take cognizance of major corruption scandals. Hungary has also adopted the Council of Europe and OECD anti-corruption pacts (but not the Council of Europe Convention on Money Laundering), and its EU accession requirements include systems of international legal cooperation. There is also a Public Procurement Council that reports to Parliament and monitors the enforcement of government contracting rules, including public procurement tribunals that so far have heard some 700 complaints. The Chief Prosecutor's Office reported 455 registered criminal cases on corruption offenses during 1998.[133] At the forefront of these efforts, especially as they concern potential abuses of public resources, is the State Audit Office, the external financial control body. It is accountable to parliament, which also appoints its senior officers, and has jurisdiction over: institutions managed from the state budget, subsidies to other entities and levels of government, state asset management, the financial affairs of the National Bank of Hungary, and the financial management of political parties. It has authority to request information and documents, and in defined circumstances to compel their production, to freeze assets, and to block expenditures.[134]

---

[131] EU, *Regular Report from the Commission on Progress towards Accession: Hungary*, November 4, 1998 and October 13, 1999.
[132] *Id.*
[133] *Id.*
[134] Act XXXVIII of 1989 on the State Audit Office.

Chapter VI: Lessons

The narrative of Hungary's escape from a downward spiral of venality, financial distortion, and collapse does not neatly fit the heroic template of graft-busting stories. Indeed, one of Hungary's enduring weaknesses has been its inability to bring major wrongdoers to book. The story is, nevertheless, heroic in its own way, and it is indeed a tale in which reform defeats endemic corruption. A reversal of this result would have been enormously costly. Even a very conservative estimate of Hungary's losses to financial corruption in the 1990s would put them well into the hundreds of millions of dollars. An adverse result, such as a Russian-style kleptocracy, would have increased the costs by a large multiple. There are lessons here for reformers in comparable situations.

The best defense is a good offense: The most important formal restraints on corruption are usually the hardest to build: independent and capable judiciaries, procuracies, audit institutions, civil service systems, and constitutional checks and balances. As these "defenses" are coming into existence or being strengthened, the best way to attack corruption may be not to *attack* it at all, but to close off avenues and reduce its appeal through an "offensive" strategy of economic liberalization and restructuring. This includes fostering new business starts and competition, establishing the foundations of good corporate governance, and strengthening the prudential standards of the banking system. But it is also critically important to bear in mind that effective governance and curtailed corruption cannot simply be legislated. The more fundamental requirement in transition environments like Hungary's is a comprehensive shift in ownership structures and incentives. Hungary accomplished this, despite the errors and setbacks in its reform efforts. Clarifying property rights and restructuring ownership enabled market discipline to take root. Most of the potential oligarchs who might have stolen the lion's share of assets and stopped reform in its tracks either were coopted into retirement in the early period, looted the firms they got hold of until bankruptcy started to bite or the bailouts ended, or learned how to make money at least semi-legitimately.

Profits are best when they're profitable: The commonsense route to economic takeoff goes badly awry when firms and banks are not motivated by (corporate) profit. This happens for several reasons. First, a very insecure environment of law and order, as well as an imploding economy, generates several varieties of cash-avoidance and account manipulation. Second, where state policy implementation and the fiscal system are still closely tied to the enterprise and banking sectors, this perpetuates soft budget constraints, thus encouraging firms and banks to place higher priority on extracting resources from the state than on restructuring for the market. Firms and banks need to be cut off from access to the treasury and made to fend for themselves. Third, a pattern of dirty privatization can put the economy on a path of theft and self-dealing rather than value-creation. This can be self-perpetuating when the "robber barons" rising from the scrum of early privatization find it easy to use their leverage against policymakers, bureaucrats, and competitors. Lastly, badly designed privatization, even if it's clean, can foster such undesirable patterns by fragmenting ownership, thereby putting effective control into the hands of incumbent management. All of this means that attention must urgently be paid to shoring up law and order, and building an institutional framework to buttresses transparency, competition, and financial discipline. Hungary did so.

Yes, "incrementalism" can work: Hungary made a conscious decision to undertake privatization at a deliberate pace and largely case-by-case. This was especially true of bank privatization. It enabled Hungary to do a number of critically important things: to plan appropriate forms of privatization, to restructure in order to maximize sale values and post-privatization performance, and to put a much stronger framework of law and regulation in place *before* most privatizations took place. Rapid privatization, after the pattern of the Czech and Russian voucher privatizations, might well have led it down the path of massive asset-diversion and corruption. But deliberation exacted its own price. The establishment of privatization policy and the State Property Agency took too long by most accounts, and this encouraged enterprise managers to engage in spontaneous privatization in the intervening legal vacuum. Obviously, this would have been still worse had restructuring and privatization been further delayed – or had they not happened at all. The key is to cut one's losses and move on. Hungary did so, in part, by investing significant energy in building market institutions and the rule of law. Indeed, it also privatized quickly where it needed to (shops and small SOEs).

Strategic foreign investment can make the critical difference: Foreign investment played a defining role in the broadly successful outcome of Hungarian privatization, especially in the banking sector. Hungarian economists agreed that voucher privatization was the wrong approach and would be a disaster, leading to dispersed outside ownership and predominantly insider control. Strategic FDI is believed by some to have "saved" Hungary from economic stasis, and with it major corruption and theft. An important specific impact of foreign investment, apparently, was the dissolution of many of the tight and shadowy networks linking enterprises together, frequently with banks, in large corporate groups. Not only do foreign investors (or at least Western ones) tend to insist on information transparency and legal accountability, but the corporate due diligence carried out in the context of major foreign acquisitions aims at exposing all significant liabilities and corporate relationships – and frequently results in simplifying and clarifying the picture. This kind of change has been fundamentally important for the transition in Hungary.

Binding outside constraints can push reform: In several instances, policymakers in Hungary had their hands tied by exogenous conditions. This is sometimes a prelude to crisis, sometimes a spur to reform. In Hungary, privatization to foreign investors was most directly driven, it appears, by the need for cash to address a heavy fiscal imbalance. The overriding problem of the public debt overhang meant that the government had to sell companies for the best return, which meant divesting controlling shares in banks and firms with good prospects, and soliciting interest from investors abroad. The World Bank appears to have played an important role here, extending an adjustment credit and keeping pressure on for privatization. The EBRD, as an investor, sought to bolster corporate governance in the banks and firms in which it invested, enforcing control rights and advising on reforms. U.S. Treasury advisors leveraged international disciplines at times, in assisting the government with bank privatizations. The requirements of EU accession have probably played an even more important role in encouraging effective reform of the financial sector, given the EU's detailed monitoring and the prize of EU membership at the end of the process. Thus, international standards and regimes can directly affect domestic governance, acting as a disciplining force, providing political cover, and thus enabling policymakers to hold the line on tough decisions.

Hard budget constraints don't come easy: "Legislative shock therapy" was Hungary's initial attempt to lock hard budgets into the financial and real sectors, but it had mixed results. One important benefit for the long term was to introduce much greater informational transparency into enterprise and bank finances. However, the new laws on accounting, banking, and bankruptcy were too harsh in the short term. They appear to have been slightly mis-targeted, they created a number of perverse incentives, and they helped deepen a serious recession. Thus, in the short term, this approach failed to take into account the need for crisis-driven accommodation: of overdue bank loan repayments, of unpaid trade credits, and of tax arrears. This accommodation appears to have taken place anyway, but in informal, sometimes illegal, ways that favored cronyism over transparency, and created more hardship than necessary. In other words, the theory that hard budget constraints had to be imposed quickly clashed with realities on the ground, and the reform legislation failed to counteract much stronger incentives arising from mixed ownership structures. In the long term, moving to a modern regime of accounting, banking regulation, and bankruptcy has become a key ingredient in Hungary's success, once restructuring gained momentum.

Bailouts are usually addictive: In 1992, Hungary appears to have approached its massive debt problem with the idea in mind of a once-and-for-all debt restructuring package. It immediately undermined this by dedicating far too few resources to resolving the problem, relieving debts but not addressing underlying problems of restructuring and competitiveness, and permitting managers both to maneuver to maximize their program benefits and to lobby for more. These problems led to further bailouts, mounting costs, and expanding collusion and corruption – until the last program addressed these issues. The latter hardened banks' and enterprises' budgets, in a sense, by providing a more adequate capital infusion on condition that the real parties in interest structure the workout, and by sending a signal that the time for bailouts was ending and the time for accelerated privatization beginning. Hungary's persistent efforts did pay off in the end, but the fiscal cost was staggering and is still being repaid.

State ownership can be domesticated if it's small enough: As with any story about combating corruption, this too is in important ways a story of checks and balances. One of these, which is not often described as such, is the massive divestment of state enterprises and banks itself. The case of Hungary seems to suggest that privatization can carry a transition economy across a threshold where the extent of state ownership is simply too insignificant to enable government to exercise control – for good or bad. This threshold will vary from place to place, though a safe target might be a maximum of about ten percent.[135] The effect of passing below such a threshold can be cumulative, since state entities have usually owned multiple cross-shareholdings in networks of firms and banks. The impact of divestment depends, of course, on the existence of several other checks and balances. One essential dimension is effective corporate governance, in which ownership percentages provide equivalent strength of control, real protection exists for minority shareholders and against equity dilutions, self-dealing and connected transactions are policed, and decisions duly taken are actually enforceable at law. In this sense, the environment of transition brings corporate and public sector governance into close mutual dependency.

Banks as well as bureaucracies need internal checks: Another critical component of strong financial governance is protection for the political and professional independence of key personnel. The areas where this appears most evident include central banks, banking supervision departments, state property funds, state-owned banks, and strategic state-owned enterprises. This also applies to private banks and enterprises. State ownership, especially of minority shares, will not necessarily create a "grabbing hand" – this requires subordinate, or at least highly cooperative, appointees in the affected economic entities. While such an outcome is more usual in transition countries than not, divestment combined with factual independence of such institutions from political intrusion can make it less likely. These larger-scale changes need to be accompanied by internal changes (in state and private entities) that insulate decisions about

[135] This should not be read as an endorsement of privatization at any cost, anywhere. Capable states face some difficulties with government-owned commercial entities, but these are often not severe. By contrast, as we have argued, transition states tend to be "soft" or incapable, hence continued state ownership poses much more severe challenges.

business planning, investments, loan approvals, and the like from immaterial concerns such as cronyism at the top. This means shortening the agency chain, thus reducing information asymmetries, mismatched incentives, and potential opportunism, and credibly holding the decision-maker responsible for efficient use of resources. Hungary's institutional reforms have addressed this need. This has reduced the reach of politically-driven corruption in state and commercial organizations.

Pluralism can strengthen economic governance: Last, a theme that receives less attention than it deserves in analyses of economic institutions: democratic pluralism can also provide an important check in this area. This, too, depends on several complementary factors such as transparent government and corporate accounts, an active press, a functioning independent judiciary, and some level of legislative oversight. Under these conditions, democratic accountability can help deter (or at least punish) the most egregious and corrupt forms of economic mismanagement. The outcome of the Postabank scandal, for example, suggests that it is harder for corrupt bankers to buy reliable support from across a plural political spectrum. Functioning democracies, buttressed by effective economic institutions and transparency mechanisms, make post-communist kleptocracy harder to establish. In this sense, Hungary's democratic politics enabled it to escape the worst failures of transition – but the price of sustaining this success, as always, is eternal vigilance.

Bibliography

Abel, Istvan and John Bonin (1994) "Financial Sector Reform in the Economies in Transition: On the Way to Privatizing Commercial Banks" in Bonin and Szekely (1994).

Adams, James (1990) *The Big Fix: Inside the S&L Scandal.* NY: Wiley.

Anderson, Ronald and Chantal Kegels (1998) *Transition Banking: Financial Development of Central and Eastern Europe.* Oxford: Clarendon Press.

Balassa, Akos (1996) *Restructuring and Recent Situation of the Hungarian Banking Sector*, NBH Workshop Series, no 4.

Balcerowicz, Ewa, Leszek Balcerowicz, Cheryl Gray, and Iraj Hoshi "Introduction and Overview" in Balcerowicz L. et al (1998).

Balcerowicz, Leszek, Cheryl Gray, Iraj Hoshi (eds) (1998) *Enterprise Exit Processes in Transition Economies*. Budapest: CEU Press.

Bergloff, Erik and Gerard Roland (1998) "Soft Budget Constraints and Banking in Transition Economies," *Journal of Comparative Economics* 26, pp 18-40.

Black, Bernard, Reiner Kraakman and Anna Tarassova (1999) "Russian Privatization and Corporate Governance: What Went Wrong?" Stanford Law School, Olin Program Working Paper no 178.

Bongini, Paola, Stijn Claessens and Giovanni Ferri (1999) "The Political Economy of Distress in East Asian Financial Institutions," mimeo.

Bonin, John and Yiping Huang (2000) "Dealing with the Bad Loans of the Chinese Banks" mimeo.

Bonin, John, Kalman Mizsei, Istvan Szekely and Paul Wachtel (1998) *Banking in Transition Economies: Developing Market-Oriented Banking Sectors in Eastern Europe*. Edward Elgar.

Bonin, J. P. and M.E. Schaffer (1995) "Banks, Firms, Bad Debts and Bankruptcy in Hungary 1991-94," Centre for Economic Performance Discussion Paper no 234.

Bonin, John and Mark Schaffer (1999) "Revisiting Hungary's Bankruptcy Episode," mimeo.

Bonin, J. and I. Szekely (eds) (1994) *The Development and Reform of Financial Systems in Central and Eastern Europe.* Edward Elgar 1994.

Budina, Nina, Harry Garretsen and Eelke de Jong (1999) "Liquidity Constraints and Invesment in Transition Economies: The Case of Bulgaria," mimeo.

Chen, Baizhu ; Dietrich, J. Kimball ; Feng, Yi, eds. (2000) *Financial Market Reform in China: Progress, Problems, and Prospects.* Boulder and Oxford: Westview Press.

Desai, Raj and Itzhak Goldberg (1999) "The Vicious Circles of Control: Regional Governments and Insiders in Privatized Russian Enterprises," mimeo.

Dilova-Kirkowa, Sonya (1999) "Corporate Governance in Bulgarian State-Owned Banks, 1992-1997," *Post-Communist Economies*, vol 11, no 2.

Djankov, Simeon (1999) "Ownership Structure and Enterprise Restructuring in Six Newly Independent States," mimeo.

Economist Intelligence Unit (1999) *Country Profile: Hungary*.

Fletcher, C. Edward (1995) *Privatization and the Rebirth of Capital Markets in Hungary***,** McFarland & Co.

Frydman, Roman, Cheryl Gray and Andrej Rapaczynski (eds.) (1996) *Corporate Governance in Central Europe and Russia.* Budapest: Central European Univ Press.

Gero, Barnabas and Balazs Vedres (1998) "Interlocking Comrades: An Analysis of the Structure of Interlocking Directorates in Post-Communist Hungary," draft paper.

Gray, Cheryl, Sabine Schlorke, and Miklos Szanyi, "Hungary's Bankruptcy Experience, 1992-3" in Balcerowicz, L. et al (1998).

Gros, D. and A. Steinherr (1995) *Winds of Change: Economic Transition in Central and Eastern Europe*. Harlow: Longman Group.

Grosfeld, Irena (1994) "Financial Systems in Transition: Is There a Case for a Bank Based System?" CEPR Discussion Paper no. 1062.

Grosfeld, Irena (1998) "Why Does Exit Matter? Exit, Growth, and Other Economic Processes in Transition Economies" in Balcerowicz, L. et al (1998).

Hellman, Joel, Geraint Jones, Daniel Kaufmann and Mark Schankermann (2000) "Measuring Governance, Corruption, and State Capture: How Firms and Bureaucrats Shape the Business Environment in Transition Economies," World Bank and EBRD Policy Research Paper no 2312.

Hendley, Katherine, Barry Ickes, Peter Murrell, and Randi Ryterman (1997). "Observations on the Use of Law by Russian Enterprises." *Post-Soviet Affairs*, 13:1, pp 19.

Horvath, Agnes and Balazs Zsamboki (2000) "The Implementation of European Banking Directives in the Hungarian Banking Sector," draft paper for National Bank of Hungary.

Johnson, Simon, Peter Boone, Alasdair Breach and Eric Friedman (1998) "Corporate Governance in the Asian Financial 1997-98," SITE Working Paper no 137.

Johnson, Simon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer (2000) "Tunnelling," mimeo.

Karvalits, Ferenc (2000) "Restructuring, Consolidation and Recent Developments of the Hungarian Banking Sector" mimeo.

Klitgaard, Robert (1988) *Controlling Corruption.* Univ of California Press.

Kroszner, Randall (1998) "On the Political Economy of Banking and Financial Regulatory Reform in Emerging Markets," draft paper.

La Porta, Rafael, Florencio Lopez-de-Silanes and Andrei Shleifer (2000) "Government Ownership of Banks," NBER Working Paper no 7620.

Li, David (2000) "Insider Control, Corporate Governance, and the Soft Budget Constraint: Theory, Evidence, and Policy Implications," in Chen et al (2000).

Maskin, Eric and Chenggang Xu (1999) 'Soft Budget Constraint Theories: From Centralization to the Market," mimeo.

Meyendorff, A. (1998). "Tax Avoidance and the Allocation of Credit." Draft paper, May 5, 1998.

Mihalyi, Peter (2000) "FDI in Hungary: The Post-Communist Privatization Story Reconsidered," mimeo.

Mihalyi, Peter (2000b) "Restructuring of the Bank and Insurance System" (trans.) Bank Reviews. Vol 1 pp. 31-53, Vol 2 pp.29-54.

Mizsei, Kalman (1994) "Bankruptcy and Banking Reform in the Transition Economies of Central and Eastern Europe" in Bonin and Szekely (1994).

Mizsei, Kalman (1997) "Privatisation of Individual Banks or the Banking System?" OECD Advisory Group on Privatisation.

Mortimer, Kate (1995) "Banking Privatization in Poland and Czechoslovakia," in Rostowski (1995).

Olson, Mancur (2000) *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*. NY: Basic Books.

Oszabo Attila, Zoltan Siposs, Eva Vajda and Tamas Perczel. (1998) "*Bank Ban*" ('Bank on the Brink'). *Elet es Irodalom* (Life and Literature). Budapest, vol.15:3-4.
-- Continuation: Vajda, Eva (1998) "*Bank Ban II*." vol. 31:3.); Oszabo, Attila and Eva Vajda (1998) "*Bank Ban III* " vol. 45:2-3; (1999) "*Bank Ban IV"* vol. 24:4.

Oszabo Attila and Eva Vajda. (1999) "*Romlas Viragai*" ('Flowers of Evil'*). Elet es Irodalom.* vol. 22:4-5.
-- Continuation: (1999) "*Romlas Viragai."* vol. 23:3-4.

Perotti, Enrico (1999) "Banking Regulation under Extreme Legal Underdevelopment: Lessons from the Russian Meltdown," mimeo.

Perotti, Enrico and Stanislav Gelfer (1999) "Red Barons or Robber Barons? Governance and Financing in Russian Financial-Industrial Groups." SSRN.

Pistor, Katarina and Joel Turkewitz (1996) "Coping with Hydra: State Ownership after Privatization" in Frydman et al (1996).

Rostowski, Jacek (ed) (1995), *Banking Reform in Central Europe and the Former Soviet Union* Central European Univ Press.

Schaffer, Mark (1997) "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence," CERT Discussion Paper no 97/20.

Andrei Shleifer and Robert Vishny (1998) *The Grabbing Hand: Government Pathologies and their Cures.* Harvard Univ Press.

Stark, David (1990) "Privatization in Hungary: From Plan to Market or From Plan to Clan?" *East European Politics and Societies* 4: 351-392.

Stark, David (1996) "Networks of Assets, Chains of Debt: Recombinant Property in Hungary" in Frydman et al (1996).

Stiglitz, Joseph (1999) 'Whither Reform? Ten Years of the Transition," World Bank Conference on Development Economics.

Tokes, Rudolf (1996) *Hungary's Negotiated Transition: Economic Reform, Social Change and Political Succession.* Cambridge.

Toth, Istvan (1999a) "Ownership Structure, Business Links and Performance of Firms in a Transforming Economy: The Case of Hungary" Institute of Economics, Hungarian Academy of Sciences Discussion Papers.

Toth, Istvan (1999b) "Some Factors of Corruption in a Transforming Economy: The Case of Hungary," mimeo.

Toth, Istvan and Andras Semjen (1999) "Market Links, Tax Environment and Financial Discipline of Hungarian Enterprises," Institute of Economics, Hungarian Academy of Sciences Discussion Papers.

World Bank (1996) *From Plan to Market: World Development Report 1996.* Oxford.

World Bank (1999) *Hungary: On the Road to the European Union*. World Bank Country Study.

Zhu, Tian (2000) "Restructuring China's State-Owned Enterprises: A Corporate Governance Perspective" in Chen et al (2000).